Part One

FROM RAIDERS TO ACTIVISTS AND EVERYTHING IN BETWEEN

Chapter 1

Growth of Activism and Why Corporate Raiders Aren't Around Anymore

The past few years have seen a major increase in the number of activist hedge funds in the United States and abroad. As of September 2006, Hedge Fund Research Inc. (HFR), a Chicago-based database and analysis company, estimates that roughly 150 full-time activist hedge fund managers have functioning investment vehicles—roughly double the 77 activist managers that existed in 2005. Activist funds in 2006 more than doubled to $117 billion in assets, from roughly $48.6 billion in assets in 2004, according to HFR (see Figure 1.1).

Also, activists appear to have produced strong results by outperforming the marketplace over the past number of years. In 2004, when the Standard and Poor's (S&P) 500, a noted benchmark of large-capitalization companies, returned 10.86 percent, activists produced 23.16 percent,

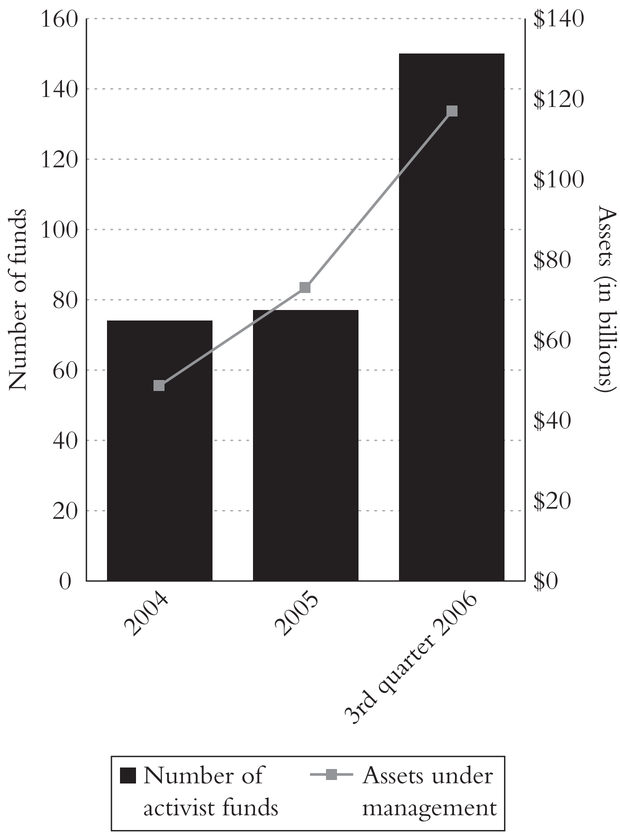

Figure 1.1 Hedge Fund Research Inc. 2006
SOURCE: Hedge Fund Research Inc.

according to HFR. In 2005, activists returned 16.43 percent while the S&P 500 reported 4.91 percent. In 2006, activists produced 16.72 percent, while the S&P 500 returned 15.78 percent. As the financial crisis expands, many new opportunities have emerged for activist hedge fund managers with the capital to invest. In an October 2008 report, Philadelphia-based consultancy Hedge Fund Solutions estimated that 1 in 10 companies in the United States were trading below their cash/share value. There are similar valuations in Europe and Japan, where activism is on the rise. In the United States, Damien Park, president of Hedge Fund Solutions, counted 54 activist campaigns in August 2008, 57 in September 2008, and 50 in October 2008.

They also are engaging and agitating for change at a wider spectrum of companies, many of which for the first time are the largest of corporations in the United States and around the world. In 2008, they prodded and engaged managers at dozens of large companies, including the Zale Corporation, Whole Foods Market Inc., CSX Corporation, Sun-Times Media Group Inc., and Longs Drug Stores Corporation. Activist Jana Partners LLC's industry-expert candidates helped facilitate a $1.8 billion sale of Cnet Networks Inc. to CBS Corporation in May 2008. Other previous targets of activism include embattled Citigroup Inc., General Electric Co., ABN Amro Holding NV, Motorola Inc., Time Warner, McDonald's, Wendy's International Inc., Heinz, Vodafone Group plc, Cadbury Schweppes plc, and Kerr-McGee Corporation. The list goes on and on. But it hasn't always been this way.

How did this once small group of insurgents explode into the massive players they are today? The answer relies on various factors that have come together to make them into full-fledged activists.

For one thing, *all* hedge funds, including activists, have become recipients of additional capital from individuals and institutions. Other major factors have contributed to the rise of the transactional-focused activist industry. For example, between 2004 and 2007, an increase in the cheap availability and variety of debt and a huge spike in deal activity, including a spike in private equity buyouts are all advancing activist goals.

The collapse of Enron, Worldcom, and other major corporations has bestowed a greater credibility on shareholders that engage corporations to improve their corporate governance.[1] All that and a transforming regulatory and legal landscape that has converted once powerful corporate raiders into activists have contributed to their evolution. Meanwhile, other previously coveted strategies, such as convertible arbitrage, are experiencing diminishing returns, leading investors to seek out new approaches, one of which is activism.[2]

Let's break down the various factors, one at a time.

Factor 1: Asset Explosion

Between 2003 and 2007 hedge fund assets under management doubled to well over $1 trillion, according to HFR. By mid 2007, hedge fund

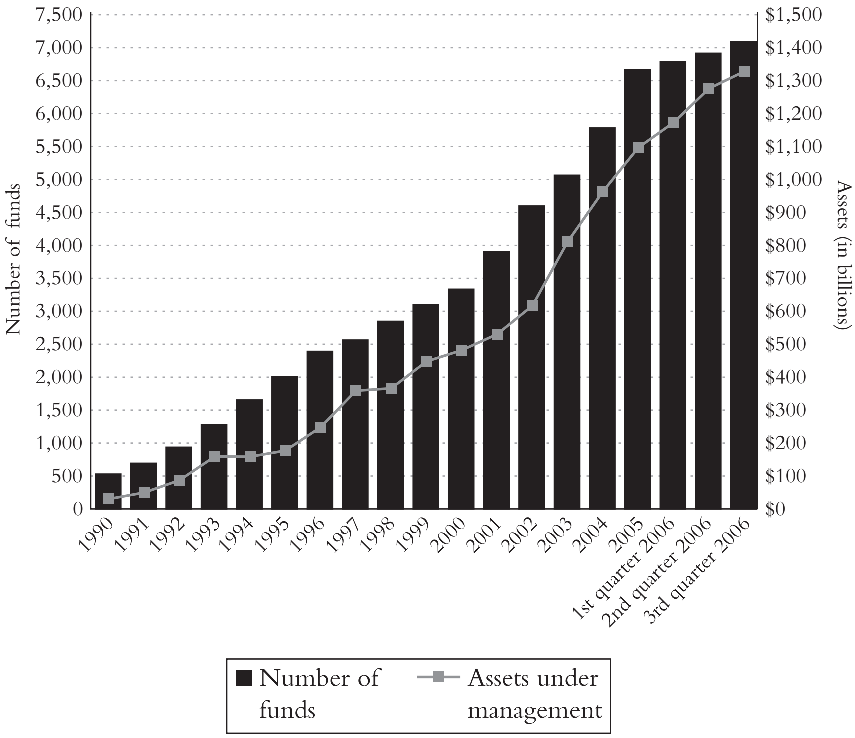

Figure 1.2 Hedge Fund Research Inc. 2006
SOURCE: Hedge Fund Research Inc.

assets were estimated to be roughly $1.6 trillion. To put things in perspective, in 1996, hedge funds managed only $256 billion. As a result of the financial crisis, hedge fund assets have dwindled as investors have pulled their money out. However, even with lower numbers, activist hedge funds and the billions they have under management represent a significantly growing piece of the total industry. Insurgent investors represent roughly 10 percent of the total hedge fund industry, HFR reports (see Figure 1.2).

Also, funds of hedge funds, which are funds that own stakes in many hedge funds, have begun investing with activists in a big way. Institutional investors such as endowments and public and corporate pension plan administrators have expanded their allocations to insurgent-type investors, particularly governance-focused managers. Consequently, activist managers are experiencing a very different investor climate than 10 years ago when their client base was more likely to be made up predominantly of a few individual high-net-worth investors. With so many assets under management, activists are under pressure to target more and bigger companies to continue producing the sweet returns their investors have grown to expect. Many traditional professional managers with expanding asset sizes are also converting into activists under the assumption that the strategy can help them maintain returns their investors have grown to expect.

Factor 2: Deal Flow

The United States and many other countries experienced a major expansion of merger-and-acquisition (M&A) activity in the early 2000s. More deals and deal makers resulted in more opportunities for activists to engage in one of their favorite share value–generating strategies: pushing companies into transactions.

In fact, a phenomenon known as *deal jumping* emerged, partially due to activist hedge fund managers pressing for more deals and better premiums on mergers. Once a company has already agreed to be acquired, another company, known as an interloper, comes in and makes its own bid for the target corporation. Activists in many cases have been driving or, at the very least, fanning the flame on the deal-jumping phenomenon. Their goal is to launch a bidding war, which will drive up the stock price.

Take Verizon's successful snag of MCI Inc. The former long-distance operator had already struck a deal to be bought by Qwest Communications International Inc. when Verizon came in with its own offer. Qwest and Verizon each made increased bids, spurred on, in part, by activist hedge fund managers pressing for higher share valuations. Shareholder Elliott Associates LP, at one point in February 2005, announced plans to vote against any MCI plan to be acquired by Verizon that was $1 billion less than a rival acquisition offer from Qwest. Elliott Associates sent that information in a letter to MCI's board. In the end, MCI's board approved Verizon's $8.1 billion bid. Even though it was 14.4 percent less than Qwest's $9.75 billion offer, it still was a significant premium to what Verizon had originally bid.[3] A few activist hedge fund managers set off a similar but much larger multibillion dollar bidding battle among banking institutions for Dutch bank ABN Amro.

Factor 3: Private Equity Funds

A tangential trend has been the recent growth of private equity (PE) companies with billions in assets. This type of investment vehicle brings together a group of investors in a fund that buys companies, typically undervalued ones, and seeks to turn them around by a variety of means such as installing new management teams that concentrate on making them more valuable. Once the portfolio business is restructured, the PE firm then either sells the business or finds another exit strategy such as a public offering. Their presence increases the potential buyer pool and likelihood that an activist's target will be acquired, particularly if activists start agitating for a merger. However, private equity firms became the first victims of the recent credit crunch. With confidence in the markets dwindling, they have temporarily disappeared as a potential buyer for a company an activist is seeking to have sold. George Mazin, a partner at Dechert LLP, notes that the increases in the number of PE funds and the assets they have under management have definitely fueled activist investing. The years 2005 and 2006 were stellar years for buyout funds.

In its 2006 report, "Management in an Era of Shareholder Activism," New York–based investment bank Morgan Joseph & Co. reports that the growth of the PE industry has created a ready market of buyers for companies that are forced into a sale by activists. "A proliferation of diverse equity funds with different mandates has broadened the array of companies that meet buyout firm requirements," Morgan Joseph reports.[4]

James Hyman, the CEO of Houston-based Cornell Companies, a builder and operator of correctional facilities, says he definitely sees a connection between activists and PE companies. Hyman was brought in as the chief executive of the Houston-based company after activists there pressured the previous CEO to step down in 2005. His stint was short. The company was sold in October 2006 to buyout shop Veritas Capital of New York.[5]

"They are co-dependent enablers," Hyman says. "The PE companies encourage the hedge fund guys to put companies in play and the activists take positions in companies and pressure for auctions enabling private equity firms to get a hold of divisions or entire companies they might otherwise not have been able to."

A connected phenomenon is that activists themselves in some cases have emulated buyout shops by making bids and buying companies

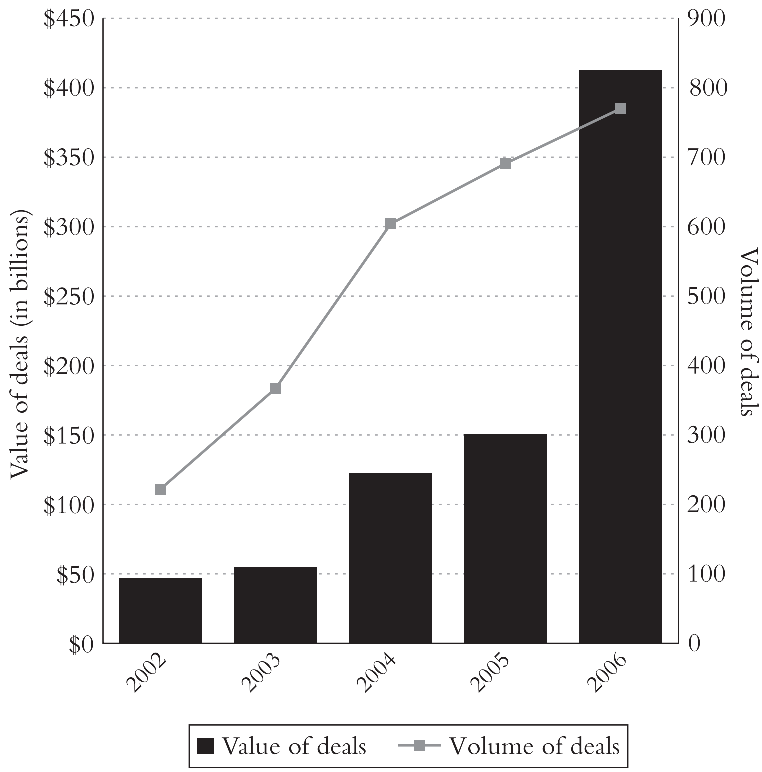

Figure 1.3 Mergermarket, an M&A intelligence and research service, 2006
SOURCE: Mergermarket, an M&A intelligence and research service, 2006.

with the intention of turning them around. Certain activists would prefer a strategic or traditional PE company to ultimately make the acquisition, but buyout shop offers and acquisitions contributed to the explosive M&A environment (see Figure 1.3).

In addition to lending for leveraged buyouts, corporations had access to much more debt financing for other purposes than ever before, and the cost of all that debt was lower than it had ever been before. This new source of cheaper debt lent itself well to the activist manager who pressed corporate executives into completing a leveraged recapitalization—in other words, raising debt levels and using the proceeds to buy back shares or issue a special shareholder dividend. Morgan Joseph's Lampert points out that company CEOs, under pressure from deal-hungry activist shareholders, had a wide variety of financing options available to them as they either contemplated taking the company private or engaging in a leveraged recapitalization.

New York-based hedge fund and buyout firm Cerberus Capital Management LP, an early adopter of the concept of hedge fund debt lending, has provided financing capital for over 10 years. In 2006, the mega fund, named for a three-headed dog that in Greek mythology guards the gates of hell, acquired General Motors Acceptance Corporation (GMAC), the financing unit of General Motors. Later in 2007, it made an even more astonishing acquisition, picking up U.S. automotive giant Chrysler Group from DaimlerChrysler AG for $7.4 billion. That deal more than any other transaction has propelled buyout shops and hedge funds out of obscurity and into the national debate. However with the markets in turmoil, both Chrysler and GMAC have fallen on difficult times. Both auto companies sought and received billions in government bailout funds in 2008 and 2009.

Factor 4: Fraud

The collapse of Enron Corporation in 2001, followed shortly by the implosion of WorldCom Inc., Global Crossing Inc. and the emergence of fraud at several other major corporations, sent a loud and clear message to the United States government. Lawmakers on Capitol Hill in Washington passed laws seeking to make sure corporations wouldn't misappropriate millions of dollars again. In 2008, a whole series of other regulatory problems, dealing with mortgages and derivatives, led to the collapse of Lehman Brothers and the government mega-bailouts of Bank of America, Citigroup, and American International Group. In response, regulators again took up legislative steps to take control of markets and to beef up enforcement of the financial sector.

The landmark Sarbanes-Oxley Act (SOX), co-authored by Senator Paul Sarbanes (D-MD) and Representative Michael Oxley (R-OH), passed in 2002 and made major stabs at reforming boards and accounting practices. Controversial corporate governance rules requiring chief executive certifications and auditor independence followed shortly afterward. Separately, The Nasdaq Stock Market Inc. (NASDAQ) and New York Stock Exchange adopted regulations that would require their member companies to have more independent directors, with little or no financial or family ties to corporate management. These regulations sought to respond to the problem of boards composed predominantly of insiders that were more interested in keeping the CEO happy rather than satisfying the company's shareholder base. Those governance rules and the financial crisis that has emerged in 2008 and 2009 created an opportunity and a ready audience for governance focused activists and their engagement style. Previously passive institutional investors have been willing to give activists a chance, especially if a central part of their campaign focuses on a lack of independent directors on a particular board. In the environment of the market meltdown, institutional investors are even more likely to support activists that have a long term governance agenda for corporations or financial institutions. When activists focus on governance issues, in recent years, they have gained credibility, which contributes to their ability to provoke change. Burned by corporations in the past, institutional investors are now more likely to support an activist that wants to put a director or two on a corporate board, as part of their effort to make corporations more accountable to shareholders. "There have always been underperforming companies and underperforming boards, but there haven't always been a significant number of funds out there that were willing to challenge them," says Morgan Joseph's Andrew Shiftan.

In the pre-Lehman era, institutional managers would either vote with their feet by selling their stakes in companies they had lost confidence in or hold on to the shares and accept management problems. As the financial crisis has emerged many previously passive institutional investors have either thrown their support to insurgents or become activists themselves.

Institutional investors such as pension funds that have invested billions in public securities markets are beginning to understand the importance of strong governance at corporations, says Corporate Library's Nell Minow. "They're recognizing that aiding an activist's efforts may be the best way to bring in the governance changes they recognize as being necessary at a corporation," she says.

Hedge Fund Solutions' Damien Park says that he agrees that activists with the right intentions can help improve the governance of corporations in a way that produces long-term share improvement. However, he argues that real governance activists are patient and understand that improvements take time. At the same time, he says, there are many fakes out there who claim to be governance experts as part of their effort to achieve a personal gain at the expense of other investors. CEOs have responded to both the fake and real governance focused activists by finding ways to leave the public markets. The hike in regulatory related costs, along with the increased difficulty many companies faced finding willing and able directors, all began to contribute to the trend of going-private transactions. In November 2006, a private-sector group headed by Glen Hubbard, dean of the Columbia School of Business, and John Thornton, chairman of the Washington think tank Brookings Institution, and former president of Goldman Sachs & Company, produced a report pointing out that regulatory requirements associated with SOX were a major contributor to why companies sought to exit the public market. The report pointed out that section 404 of the law, financial reporting of corporate internal controls, created a particularly hostile world for many public companies, particularly smaller ones.[6] According to the report, the cost for companies complying with section 404 in the first year was, on average, $4.36 million.[7]

The new price of being public, coupled with a growing weariness on the parts of many corporate CEOs to the growing challenge of meeting Wall Street's short-term earnings expectations, have all contributed to the recent trend of companies seeking a private exit. Activists have recognized these factors and, together with institutions, they have been there to give companies that final push toward leveraged buyouts.

Factor 5: Historical Context

To figure out how activists operate, it first is necessary to understand their roots. Where they came from explains a great deal about their present strategy. Corporate raiders of the 1980s, the forefathers of today's agitators, have inspired and educated many present-day activists. In fact, activists today probably would not exist without the groundbreaking insurgencies of these predecessors.

But even before the 1980s, there were shareholders agitating for change at companies, though only a handful at any one time until now. In the 1940s and 1950s, investors such as Thomas Mellon Evans, Louis

Wolfson, and Leopold Silberstein pressed undervalued companies they believed had too much cash on their balance sheets into making changes. In many ways that period represented the Wild West of activism because it took place before a regulatory regime existed that required any serious disclosures of investment information. These insurgent investors could buy huge stakes in companies, before anyone knew they were there. Diana Henriques explains in her book *White Sharks of Wall Street* how Wolfson succeeded in his goal of provoking change at Montgomery Ward, a catalog retailer based in Chicago, Illinois.[8]

In 1954, Wolfson acquired a 6.5 percent stake in Montgomery Ward and launched a campaign to oust directors from the company's board. His ultimate goal was to remove the department store chain's CEO, Sewell Avery. Only 30 percent of investors backed Wolfson's slate of board nominees, though that was enough to gain three director positions on the board and for Avery to step down. Montgomery Ward subsequently made other changes Wolfson agitated for and the company's stock improved dramatically. Other target companies for the raiders of the 1950s included Pratt & Whitney and Twentieth Century Fox.[9]

Certainly, some of the corporate raiders of the 1980s were inspired by these early agitators. But whether the larger group of activists seeking changes at companies today in the United States and around the world are just an extension of these early insurgents or a whole new phenomenon is a matter for debate. First, a definition: Corporate raiders in the 1980s traditionally would make hostile bids for corporations. In some cases, they acquired the business and liquidated it by selling off various divisions and assets of the purchased company, kind of an expansive garage sale. In essence, the corporation no longer exists as it did before the raider showed up. In other cases, to avoid being liquidated, targeted corporations or other large investors would offer insurgents a premium for their shares, known as greenmail, as an incentive to drop their aggressive campaigns and leave the company alone. Greenmail, a special payment other investors wouldn't receive for their shares, was seen as part of the "greed" environment associated with the 1980s. The strategy for many raiders was to give the company two options: sell the business to a strategic buyer or make the insurgent go away with an offer of greenmail. Either one of these approaches typically led to profits for the raider.

But unlike most present-day activists, 1980s-era raiders did not seek to improve value by engaging collaboratively with management of their targets. Nor did they seek to make corporate governance changes such as pressuring boards to alter executive compensation plans as a means of improving the share price. (In many cases, that was because raiders didn't have the tools to do so.)

These raiders have at some level motivated the group of activists pressing for changes today. For one thing, many activists leading the movement worked for raiders such as Carl Icahn, Asher Edelman, Ronald Perelman, and T. Boone Pickens. As you can read from that list, some of the raiders of the 1980s are still present and active today in a big way, and many of them operate with some of the same incentives as they did in the 1980s, though they must play by the new rules of the game.

For example, billionaire Icahn is still busy pushing companies around in many of the same ways he did 20 years ago. In 1980 and 1981 he took on Hammermill Paper Company.[10] Icahn acquired a 10 percent voting stake in the paper company and prepared plans to complete a hostile takeover. He hoped to take over the company and auction off its assets, leaving nothing behind. Instead, Icahn ended his hostile plans after the company bought back his stake at a premium over the market price.[11] In 1984, Icahn acquired American Car & Foundry Company, a consolidated railroad car manufacturer.[12] He liquidated some assets and improved the company's earnings.

In 2006, Icahn made a $10 billion unsolicited bid for South Korean cigarette manufacturer KT&G Corporation, reminiscent of his hostile bids of the 1980s. While the bid looks familiar, Icahn's target, located on the other side of the planet, shows that some things are changing. Part of what has changed is that Icahn and the remaining raiders of the 1980s are working in an environment surrounded by many of their progeny. Icahn's KT&G bid was made with the support of newcomer insurgent Warren Lichtenstein, whose team discovered the investment opportunity in the first place. Lichtenstein eventually attained a seat on KT&G's board, and now is working collaboratively with the company's management to improve share value—a very un-raider-like move. Icahn maintains his aggressive insurgent approach today, in part, because his reputation for being a corporate raider makes it difficult for him to do anything else. "It's hard for Carl Icahn to call up a company and say, 'I'd like to learn about your business,'" quips ValueAct Capital's Jeffrey Ubben.

In addition to Icahn, oilman-turned-corporate raider T. Boone Pickens is famous for his insurgencies at energy companies in the 1980s. His strategy: first buy, then split up companies and sell them in a way that improved shareholder value. The experience of a corporate raid can be particularly painful for people working for businesses targeted by raiders, particularly for the ones who were laid off in the reshuffling. Pickens is most famous for his takeover efforts at energy companies. He sought to break up Cities Services Company (now part of Citgo) in 1982. Later he went after other energy companies, including Unocal Corporation, Phillips Petroleum Company, and Gulf Oil Corporation.[13]

Another 80s raider, Irwin Jacobs of Minneapolis, known as "Irv the Liquidator," pressured many companies into making changes.[14] In 1989 he joined forces with cosmetics and beauty products direct seller Amway Corporation to buy a 10 percent stake in rival Avon Products Inc. and pressed for a sale.[15] Other objects of his attention included the Walt Disney Company and ITT Corporation.

Working for corporate raiders makes for a great education. Two investors that would eventually strike out on their own, Emanuel Pearlman and Barry Rosenstein, first worked for Asher Edelman, a raider who instigated a series of insurgencies in the 1980s on companies such as Canal-Randoph Company, Lucky Stores Inc., and Burlington Industries Inc.[16] For example, Edelman took control of the board of Canal-Randolph, the parent company of United Stockyards. Once in charge, Edelman sold the corporation's divisions.[17]

After working for Edelman, Rosenstein launched Jana Partners, an activist fund that focuses much of its insurgent efforts on energy companies. Pearlman, who went to work for Edelman for three years after completing business school, says the experience influenced him but does not necessarily represent the strategies he employs at Liberation Investment Group, the activist hedge fund he now manages. At Liberation, Pearlman takes more of a carrot-and-stick approach. "Anything we get involved in, we're looking to be an activist," Pearlman says. "We go to the management teams and talk professionally and try to convince them to do things that are good for the company, but if that doesn't work, then we engage in more public activist efforts."

Many factors contributed to the fading of the 1980s-style raider. For one thing, a number of raiders in the late 1980s lost their investors' money on the strategy. Also, numerous securities regulations changed in the early 1990s, making it easier for shareholders to hold companies accountable to investors without the need for raids.

Corporations installed brand-new anti-takeover protections such as poison pills to ward off hostile raiders, making the strategy practically impossible to pull off. Also known as a shareholder rights plan, the poison pill is an anti-takeover provision because it permits a corporation to inundate the market with shares and prevents a hostile bidder from accumulating a controlling stake in the business without the board's approval.

Delaware, where about 50 percent of all U.S. corporations are registered, passed a law, section 203, prohibiting raiders with a 15 percent stake of a target company from completing a hostile acquisition. In essence, the law sets up a three-year freeze of company assets unless the target company's board agrees to the transaction.[18] Other states, including New York and Massachusetts, adopted similar laws. The Delaware law and anti-takeover devices forced raiders to the negotiation table with boards and executives.

Mark Schwarz, president of activist fund Newcastle Capital Group LLC, points out that another major reason why the heyday of the corporate raider has passed is because insurgents today have a much more difficult time than their predecessors in the 1980s raising the debt financing they need to launch a hostile bid. During the 1980s, famous financier Michael Milken of Drexel Burnham Lambert Inc. provided junk bond–driven financing offers for hostile bids. Milken went to prison on finance-related charges and now-days that ready financing either no longer exists or is very difficult to come by. Today, Schwarz says, activists no longer can make hostile offers for large U.S. companies because major lending institutions won't or aren't permitted to provide the financing to insurgents for hostile takeovers. In fact, the Federal Reserve Board responded to the explosion of corporate raiders by establishing margin rules that prohibited shell corporations from borrowing debt to finance hostile acquisitions.[19] The rules were targeted at raiders, such as Icahn and Pickens, who typically formed shell corporations when launching hostile bids.

Instead, present-day activists must raise capital from their own investors, for the most part, to complete hostile unsolicited buyouts.

In practicality, that means hostile acquisitions are much less frequent and typically don't take place with plans to break up the company and sell it in pieces. In some cases, activists join forces to raise the capital needed to make a hostile buyout offer. A small number of high-profile insurgents have the capital and the will to launch hostile bids. But in most cases, insurgent shareholders, lacking the funds, no longer make hostile bids.

Public perception played a roll as well. Critics of corporate raiders have labeled the shareholder class as a group of disgruntled investors that never were particularly fond of the idea of improving the companies they targeted. Some activists that have popped up over the past five years may fit that mold, but it doesn't represent the majority of activists. Instead of seeking first to break up companies, many activists look to enhance value by finding ways to improve the business—intact—by collaborating with executives, often behind the scenes.

Those individuals that believe activists have emerged and stand for something vastly different than corporate raiders of the 1980s generally point to a watershed event that took place in 1986. That was the year Ralph Whitworth launched United Shareholders Association, or USA, a grassroots organization that represented small shareholders.

Whitworth, 51, today runs the extremely successful activist fund Relational Investors, which focuses on improving the governance of target companies and at the same time making money for his investors. In 2006, he was a key agitator leading to the resignation of Home Depot Chairman and CEO Robert Nardelli. Whitworth was drawn to Home Depot by what he saw as a misaligned compensation package for Nardelli, coupled with the company's unremarkable stock performance (see Chapter 6). But in 1986, Whitworth was running the USA, which received seed money from his former boss, Pickens, and other investors. Their intent was to help burgeoning, but mostly small activist, investors gain some leverage when negotiating with corporations.[20]

ISS's Pat McGurn, formerly a director of communications and research at USA, points out that the group was the first small-investor organization that focused its efforts primarily on governance and improving shareholder value. Members paid a nominal fee, roughly $50 a year, to join. At its height the organization had over 1,000 members represented by Whitworth and a team of roughly 10 people in small offices at 1667 K Street in Washington. "Fortune 500 company CEOs would come traipsing through our offices, pitching their point of view," McGurn says.

In 1989, USA launched a corporate activism program that targeted 50 companies each year that USA members identified as having some governance problem. The program, dubbed "Target 50" got off to a slow start. Only a few companies returned USA calls in the program's first year and shareholder proposals seeking to change a corporation's governance received, on average, only 17 percent support from other investors.[21] By 1993, proposals USA members introduced received, on average, 44 percent support and 22 agreements were negotiated with executives.[22] Companies agreed to remove directors with conflicts and cut out "golden parachute" severance agreements.[23] In 1992, Cooper Industries of Houston, Texas, agreed to restructure its board nominating committee to consist only of independent directors, as did Dial of Phoenix, Arizona. In 1993, Polaroid agreed to revise its poison pill bylaw to give shareholders the right to vote and remove it in the event of an all-cash tender offer for the company. Other companies that reached settlements with USA included Wendy's, Whirlpool, Time Warner, and Unisys, among many more.[24]

In addition to having a direct impact on the companies they targeted directly, the minority shareholder group also was effective in convincing regulators in Washington to give shareholders a greater voice in director elections and investor communications.

McGurn says Whitworth's recent success at Relational Investors can be traced back to his efforts at USA. Whitworth also spent some time at ISS, where he developed a better comprehension of governance style investing.[25] "At USA, Whitworth honed his skills at interacting with directors and executives," McGurn says. "He saw that he could have success in changing governance structures in a way that could spur performance."

The creation of Relational Investors in 1995 also represented a major shift from corporate raiders to governance-style activism. At the time of its launch, Relational billed itself as a unique investment fund that focused on pressing undervalued and troubled companies into improving their corporate governance practices and making other changes.

In many ways that was the first truly activist fund, breaking away from the pack of raiders. It took a much more collaborative and consensus-building approach that sought to work with executives to improve value. This was in many ways a first and is considered by governance experts as a critical moment in the transformation of raiding into activism. Relational was co-launched by David Batchelder, another investor who worked with Pickens. "He [Whitworth] changed the negative concept of corporate raider into a positive strategy of corporate governance that involved engaging management," says Liberation's Pearlman.

The emergence of Whitworth's fund also was a turning point moment for relations between institutions and activist hedge funds. Relational succeeded at gaining the support of institutions in a way that had never occurred before. Unlike corporate raiders, who typically were funded by high-net-worth individuals, Batchelder and Whitworth's fund received initial investment capital from the long-term-minded public pension fund California Public Employees' Retirement System (CalPERS). CalPERS allocated capital anticipating that Relational would engage managements and at times press undervalued and troubled companies into improving their corporate governance structures.

With CalPERS support, Relational also had an easier time attracting the backing of other public pension funds with similar mandates. All of this funding improved Relational's leverage in boardroom discussions with executives. Many activists have since followed in the Relational mold of seeking to improve a company's governance structure as a means of enhancing share value.

Activists today, generally speaking, have adopted a strategy of engaging management of the companies they target for change. The first part of most activists' strategy is to meet executives and discuss ideas for improving the company's value in a friendly, collegial manner. It's true that some activists often start their efforts by rattling their swords and making demands. But most activists try to work things out privately, and when that fails, their strategy becomes more raider-esque or insurgent-like. At that point, an activist may make an unsolicited bid to provoke some reaction. "Unlike the cold, calculating strategy of corporate raiders, activists today invest in companies they believe have potential, and they try to work with management to make the companies better," says George

Mazin, a partner at Dechert LLP in New York. "It's sort of a passive-aggressive approach."

Mazin also notes that activists have investment time considerations that bear little resemblance to that of their corporate raider forefathers. While raiders have traditionally been anxious to get in and out of an investment in a year, activists are willing to stick with their stakes and continue pressing for change for two to three years and sometimes longer (still significantly shorter than many long-term institutional holders). The activist model is closer to the strategy utilized by private equity companies, which typically have, at minimum, five-year investment holding periods. The longer holding periods employed by activists has helped the investor group continue to utilize their strategy because they aren't experiencing the same high-level of capital redemptions other investment managers with shorter lockups are experiencing as a result of the market downturn. Also, raiders would typically seek to take control of a company and immediately break it up, while activists are more likely to encourage companies to find buyers themselves.

Another difference, says Morgan Joseph's Lampert, relates to valuations. He points out that a 1980s-style corporate raider typically sought to gain a modest short term profit. Meanwhile, activist investors take a more long-term perspective with the company they are focusing their attention on and generally do a better job of unlocking the value of corporations with their engagement approach. The valuations that corporate raiders received for their efforts are typically at a discount to the maximum amount shareholders could receive from the stock and what activists often can achieve, Lampert says.

Comparing benefits achieved by activists and raiders also reveals another fundamental dissimilarity between the two groups of investors. With corporate raiders, in many cases, only the insurgent obtains the benefit. With governance focused activist investors, the benefit typically goes to the entire shareholder base, including activists, institutions, and individual investors. When an activist succeeds at installing a couple of directors who are invested heavily in the stock, an argument can be made that their interests are aligned with the rest of the shareholder base. Charles Elson, director of the Corporate Governance Center at the University of Delaware, argues that even a shareholder seeking to take control of a board to replace management does not make that investor a corporate raider. The investor needs to gain the support of a majority of other shareholders to attain that goal. The result doesn't give that dissident investor a return that is disproportionate to what other investors received.

However, executives argue that an activist effort may produce a short-term benefit at the expense of long-term value. That brings us back to the concept of greenmail. Christopher L. Young, director and head of M&A research at Institutional Shareholder Services in Rockville, Maryland, says he disagrees with any characterization that categorizes all activists as short-term, raider-like opportunists looking for greenmail. He points out that greenmail, in its traditional form, may have been prevalent in the 1980s, but for the most part that phenomenon doesn't exist anymore. "Corporations will try to paint activist motives to show that they will get some sort of advantage different from what other shareholders will gain," Young says. "But these activists stimulate benefits that all shareholders receive."

In a March 2005 *Financial Times* editorial, Jana Partners' Rosenstein expressed outrage about how he and other activists have been dubbed sharks or corporate raiders.[26] In the editorial, "Activism Is Good for All Shareholders," Rosenstein argued that activists are not short-term investors. An activist's effort at a company is good news for all investors, he argues.

Chapman Capital's Robert Chapman expressed his thoughts on the traditional concept of greenmail in a letter written in 2000 responding to American Community Properties Trust CEO Michael Wilson. In the letter, Chapman refers to the real estate investment trust's shareholder base as "public partners" to emphasize how he believes executives there are partnered with their entire shareholder base. The letter also responded to a suggestion made by Wilson indicating that Chapman may have wanted the company to buy his shares at a higher value than what other investors could receive. "I have never suggested that ACPT purchase MY shares at a premium over market," Chapman wrote in April 2000.

Morgan Joseph's Lampert points out that activists succeed when they establish credibility with the rest of the shareholder base. Accepting greenmail, even once, would damage their reputation with institutional investors in every other insurgency they would ever initiate. Activists also seek to establish credibility with surrogates for the institutions, such as Institutional Shareholder Services and Proxy Governance Inc., proxy advisory services that either vote directly for institutions or make recommendations for them. Accepting greenmail would irrevocably hurt their status with these advisory companies.

CEOs and boards are also less likely to offer greenmail, in part because securities lawyers and institutional investors lately are more prepared to respond to such a proposition with a class action lawsuit against the corporation claiming they did not receive the same price themselves. "If they [corporations] begin negotiating with insurgents for greenmail takeouts, then that will open up a whole new can of worms, with other investors claiming they did not get the same returns," Lampert says.

David Chavern, chief of staff at the U.S. Chamber of Commerce in Washington, says that not all of the corporate raider greenmail tactics have disappeared. He says that today there are various shades of gray when considering greenmail. When activists press for a special dividend or recapitalization and get it, the engagement does not comfortably fit into the traditional category of greenmail because presumably all shareholders receive the same return. But, on another level, when a company agrees to return some of its cash to shareholders as a means of satisfying pestering activist investors, that activity may offend other long-term investors who would have preferred to let the company keep that capital available within the company to grow the business. "Basically, what you're comparing is the benefit for having an activist go away versus the financial return they could have received by investing the company's cash in the business," says Chavern. "I'm not sure it makes much sense to say that shareholders at large should also be required to pay for activist campaigns because then you're making the rest of the shareholders pay to support a perspective which they may or may not agree with."

He adds that even though there are many reasons why activist hedge fund managers don't engage in most of the tactics of their raider predecessors, there are some similarities that go beyond greenmail. "Corporate raiders and activists both operate from the same theory that corporations they are engaging are fat and need to be disciplined, either in terms of cost cutting or divesting divisions," Chavern says. But he adds that unlike raiders, activists try to collaborate with management to achieve their goals and the returns they receive are distributed throughout the shareholder base.

Despite the perception by some that activists remain raider-like greenmail artists, this group of shareholders has emerged to become a unique investor class all on its own. Their growth in numbers and assets can be attributed to new funding sources. Public and corporate pension funds joining high-net-worth investors have given activists credibility and heft. Governance-style activists, in a post-Lehman Brothers environment, have unleashed a movement of institutional investors pressing boards to tie executives' compensation to performance. In fact, expect an all-encompassing reform of CEO pay package regulation to take place in Washington as lawmakers and regulators grapple with the financial crisis. Already, CEOs of mega-banks receiving government bailout dollars have strict executive compensation restrictions attached to those funds. Activist investors are not only generally supportive of the new pay regime, but they also plan to point to the regulatory changes to justify their own efforts to reform CEO compensation plans. To make sure executives are working for shareholders as much as for themselves, activists are installing independent directors on corporate boards. Armed with their governance agenda, activists are becoming a major force in the wheeling and dealing that takes place in the corporate world. Unlike many of their predecessors, who were interested in acquiring businesses only for the purpose of liquidating assets, many activists now spend much of their time working privately with executives to improve their investment's governance and share value.

The next few chapters delve deeper into what activists do to provoke changes at corporations, particularly when private, behind-the-scenes collaboration breaks down. How activists make investment decisions and what strategies they employ when agitating for change will all be discussed. With a deeper understanding of their tactics and strategies, we can get into the mind of the activist.