

# The Icahn Manifesto

## Corporate Raider to Activist Investor

*“Had we but world enough, and time,  
This coyness, Lady, were no crime. . .*

—Andrew Marvell, *To His Coy Mistress* (c. 1650)

**bouleversement** \bool-vair-sub-MAWN, noun:

*Complete overthrow; a reversal; an overturning; convulsion;  
turmoil.*

—Comes from French, from Old French *bouleverser*,  
“to overturn,” from *boule*, “ball” (from Latin *bullā*) + *verser*,  
“to overturn” (from Latin *versare*, from *vertere*, “to turn”).

**O**ver the fall of 1975, Carl Icahn and his right-hand man, Alfred Kingsley, hashed out a new investment strategy in the cramped offices of Icahn & Company. Located at 25 Broadway, a few steps away from the future site of the *Charging Bull*, the iconic 7,000-pound bronze sculpture erected by Arturo Di Modica following the 1987 stock market crash, Icahn & Company was then a small, but successful, discount option brokerage with a specialty in arbitrage. Kingsley, a graduate of the Wharton School with a master’s degree in tax from New York University, had joined Icahn in 1968. Immediately impressed by his ability to quickly grasp complex transactions, Icahn had asked Kingsley what he knew about arbitrage. “Not a thing,” Kingsley had replied.<sup>1</sup> Soon Kingsley was spending most of his days arbitraging the securities of conglomerates like Litton Industries, LTV, and IT&T. Arbitrage is the practice of simultaneously buying and selling an asset that trades in two or more markets at different prices. In the classic version,

the arbitrageur buys at the lower price and sells at the higher price, and in doing so realizes a riskless profit representing the ordinarily small difference between the two. Icahn had Kingsley engaged in a variation known as convertible arbitrage, simultaneously trading a stock and its convertible securities, which, for liquidity or market psychology reasons, were sometimes mispriced relative to the stock. Litton, LTV, IT&T, and the other conglomerates had issued an alphabet soup of common stock, preferred stock, options, warrants, bonds, and convertible debt. As an options broker, Icahn used his superior market knowledge to capitalize on inefficiencies between, say, the prices of the common stock and the warrants, or the common stock and the convertible debt. The attraction of convertible arbitrage was that it was market-neutral, which meant that Icahn & Company's clients were not subject to the risk of a steep decline in the market.

Icahn and Kingsley shortly progressed to arbitraging closed-end mutual funds and the securities in the underlying portfolio. A closed-end mutual fund is *closed* because it has a fixed number of shares or units on issue. Unlike open-end funds, management cannot issue or buy back new shares or units to meet investor demand. For this reason, a closed-end fund can trade at a significant discount or, less commonly, a premium to its net asset value. Icahn and Kingsley bought the units of the closed-end funds trading at the widest discount from their underlying asset value, and then hedged out the market risk by shorting the securities that made up the mutual fund's portfolio. Like the convertible arbitrage strategy, the closed-end fund arbitrage was indifferent to the direction of the market, generating profits as the gap between the unit price and the underlying value narrowed. It was not, however, classic riskless arbitrage.

As it was possible for a gap to open up between the price of the mutual fund unit and the underlying value of the portfolio, it was also possible for that gap to widen. When it did so, an investor who had bought the units of the fund and sold short the underlying portfolio endured short-term, unrealized losses until the market closed the gap. In the worst-case scenario, the investor could be forced to realize those losses if the gap continued to widen and he or she couldn't hold the positions, which could occur if he or she failed to meet a margin call or was required to cover the short position. Unwilling to rely on the market to close the gap, Icahn and Kingsley would often take matters into their own hands. Once they had established their position, they contacted the manager and lobbied to have the fund liquidated. The manager either acquiesced, and Icahn and Kingsley closed out the position for a gain, or the mere prospect of the manager liquidating caused the gap to wholly or partially close. The strategy generated good returns, but the universe of heavily discounted closed-end funds was small. Icahn and Kingsley saw the potentially far larger universe of prospects emerging in public companies with undervalued assets. This was the new investment strategy they were shaping at 25 Broadway in 1975.

Already moribund after a decade of stagflation, an oil crisis, and a failing U.S. economy, Wall Street was sent reeling from the knockout punch delivered by the 1974 stock market crash, the worst since the Great Depression. Out of the bear market punctuating the end of the Go-Go 1960s, the stock market had rallied to a new all-time high in early 1973. From there it was brutally smashed down to a trough in October 1974 that was some 45 percent below the January 1973 peak. (The market would repeat this wrenching up and down cycle until November 1982, at which point it traded where it had in 1966, fully 16 years before.) Stocks that had become cheap in 1973 had proceeded to fall to dust in 1974. Bonds, ravaged by runaway inflation, were described by wags as “certificates of confiscation.”<sup>2</sup> Investors were still shell shocked in 1975. Even if they could be persuaded that they were getting a bargain, most seemed unwilling to re-enter the market, believing that undervalued stocks could start dropping again at any moment. If they would take a call from their broker, they simply wanted “the hell out of the market.”<sup>3</sup>

Although few could sense it, a quiet revolution was about to get under way. Icahn and Kingsley had seen what many others had missed—a decade of turmoil on the stock market had created a rare opportunity. After trading sideways for nine years, rampant inflation had yielded a swathe of undervalued stocks with assets carried on the books at a huge discount to their true worth. Recent experience had taught most investors that even deeply discounted stocks could continue falling with the market, but Icahn and Kingsley were uniquely positioned to see that they didn’t need to rely on the whim of the market to close the gap between price and intrinsic value. Kingsley later recalled:<sup>4</sup>

*We asked ourselves, “If we can be activists in an undervalued closed-end mutual fund, why can’t we be activists in a corporation with undervalued assets?”*

As they had with the closed-end mutual funds, Icahn and Kingsley would seek to control the destiny of public companies. Their impact on America’s corporations would be profound.

## **ICAHN’S WALL STREET REFORMATION**

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Icahn’s progression from arbitrageur and liquidator of closed-end funds to full-blown corporate raider started in 1976 with a distillation of the strategy into an investment memorandum distributed to prospective investors:<sup>5</sup>

*It is our opinion that the elements in today’s economic environment have combined in a unique way to create large profit-making*

opportunities with relatively little risk. [T]he real or liquidating value of many American companies has increased markedly in the last few years; however, interestingly, this has not at all been reflected in the market value of their common stocks. Thus, we are faced with a unique set of circumstances that, if dealt with correctly can lead to large profits, as follows: [T]he management of these asset-rich target companies generally own very little stock themselves and, therefore, usually have no interest in being acquired. They jealously guard their prerogatives by building ‘Chinese walls’ around their enterprises that hopefully will repel the invasion of domestic and foreign dollars. Although these ‘walls’ are penetrable, most domestic companies and almost all foreign companies are loath to launch an ‘unfriendly’ takeover attempt against a target company. However, whenever a fight for control is initiated, it generally leads to windfall profits for shareholders. Often the target company, if seriously threatened, will seek another, more friendly enterprise, generally known as a ‘white knight’ to make a higher bid, thereby starting a bidding war. Another gambit occasionally used by the target company is to attempt to purchase the acquirers’ stock or, if all else fails, the target may offer to liquidate.

It is our contention that sizeable profits can be earned by taking large positions in ‘undervalued’ stocks and then attempting to control the destinies of the companies in question by:

a) trying to convince management to liquidate or sell the company to a ‘white knight’; b) waging a proxy contest; c) making a tender offer and/or; d) selling back our position to the company.

The “Icahn Manifesto”—as Icahn’s biographer Mark Stevens coined it—was Icahn’s solution to the old corporate principal-agency dilemma identified by Adolf Berle and Gardiner Means in their seminal 1932 work, *The Modern Corporation and Private Property*.<sup>6</sup> The principal-agency problem speaks to the difficulty of one party (the principal) to motivate another (the agent) to put the interests of the principal ahead of the agent’s own interests. Berle and Means argued that the modern corporation shielded the agents (the boards of directors) from oversight by the principals (the shareholders) with the result that the directors tended to run the companies for their own ends, riding roughshod over the shareholders who were too small, dispersed, and ill-informed to fight back. According to Berle and Means:<sup>7</sup>

*It is traditional that a corporation should be run for the benefit of its owners, the stockholders, and that to them should go any profits which are distributed. We now know, however, that a controlling*

*group may hold the power to divert profits into their own pockets. There is no longer any certainty that a corporation will in fact be run primarily in the interests of the stockholders. The extensive separation of ownership and control, and the strengthening of the powers of control, raise a new situation calling for a decision whether social and legal pressure should be applied in an effort to insure corporate operation primarily in the interests of the owners or whether such pressure shall be applied in the interests of some other or wider group.*

Berle and Means gave as an example the American Telephone and Telegraph Company (AT&T), which they said had assets of \$5 billion, 454,000 employees, and 567,694 shareholders, the largest of whom owned less than one percent of the company's stock:<sup>8</sup>

*Under such conditions control may be held by the directors or titular managers who can employ the proxy machinery to become a self-perpetuating body, even though as a group they own but a small fraction of the stock outstanding. In each of these types, majority control, minority control, and management control, the separation of ownership from control has become effective—a large body of security holders has been created who exercise virtually no control over the wealth which they or their predecessors in interest have contributed to the enterprise. In the case of management control, the ownership interest held by the controlling group amounts to but a very small fraction of the total ownership.*

Icahn cut straight to the heart of the matter, likening the problem to a caretaker on an estate who refuses to allow the owner to sell the property because the caretaker might lose his job.<sup>9</sup> His manifesto proposed to restore shareholders to their lawful position by asserting the rights of ownership. If management wouldn't heed his exhortations as a shareholder, he would push for control of the board through a proxy contest—a means for shareholders to vote out incumbent management and replace them with new directors. In a proxy contest, competing slates of directors argue why they are better suited to run the company and enhance shareholder value. If he didn't succeed through the proxy contest, he could launch a tender offer or sell his position back to the company in a practice known as *greenmail*. A neologism possibly created from the words *blackmail* and *greenback*, greenmail is a now-unlawful practice in which the management of a targeted company pays a ransom to a raider by buying back the stock of the raider at a premium to the market price. Warren Buffett, who said of greenmail that

it was “odious and repugnant,” described the nature of the transaction in his 1984 *Chairman’s Letter* in characteristically colorful terms:<sup>10</sup>

*In these transactions, two parties achieve their personal ends by exploitation of an innocent and unconsulted third party. The players are: (1) the “shareholder” extortionist who, even before the ink on his stock certificate dries, delivers his “your-money-or-your-life” message to managers; (2) the corporate insiders who quickly seek peace at any price—as long as the price is paid by someone else; and (3) the shareholders whose money is used by (2) to make (1) go away. As the dust settles, the mugging, transient shareholder gives his speech on “free enterprise”, the muggee management gives its speech on “the best interests of the company”, and the innocent shareholder standing by mutely funds the payoff.*

Icahn accepted greenmail on several occasions prior to it being outlawed, on one such occasion attracting a class-action lawsuit from the shareholders of Saxon Industries, a New York-based paper distributor that fell into bankruptcy following the transaction. The lawsuit charged that Icahn had failed to disclose to the market that he had requested greenmail in exchange for not undertaking a proxy contest. When Saxon Industries announced that it had paid Icahn \$10.50 per share as greenmail, giving him a substantial profit on his \$7.21 per share average purchase price, the stock fell precipitously. According to a lawsuit filed against Icahn, upon the sudden announcement by Saxon that it had purchased Icahn’s stock, the market price of Saxon’s stock nosedived to \$6.50. While the bankruptcy of Saxon Industries was arguably more directly the result of its chairman Stanley Lurie’s accounting fraud, the complaint demonstrated two ideas: First, the inequity of greenmail. The substantial premium paid to the greenmailer comes at the cost of all shareholders remaining in the company. Second, the complaint illustrates the power of the activist campaign. Icahn’s threat of a proxy contest had pushed the stock price from around \$6 to \$10.50. Absent the possibility of a proxy contest, the stock fell back to its average pre-campaign price of \$6.50.

While gaining control gave him discretion over the operating and capital allocation decisions of the company, Icahn’s experience with the closed-end funds had taught him a valuable lesson—simply calling attention to the company’s market price discount to its underlying and underexploited intrinsic value would attract the attention of other investors. He hoped that by signaling to the market that the company was undervalued, leveraged buy-out firms or strategic acquirers would compete for control and, in so doing, push up the market price of his holding. Icahn could then sell into any

takeover bid by tipping his shares out onto the market or delivering them to the bidder. It was the classic win-win situation Icahn sought—even if he didn’t win a seat on the board, the proxy contest would act as a catalyst, signaling to other potential bidders in the market the company’s undervaluation and mismanagement.

### **Theory into Activism: Tappan Stove Company in Play**

Icahn’s first target was Tappan Stove Company, a sleepy range and oven maker still chaired by a member of its eponymous founding family, Dick Tappan, almost a century after it was founded in 1881. Tappan stock was already depressed along with the rest of the stock market following the crash in 1974. It fell off a cliff when it posted its first loss in 40 years following a disastrous move into a new market for Tappan—heating and cooling—and a slump in its old home building market. Kingsley, who identified it as an attractive candidate, said:<sup>11</sup>

*At the time we took our position in Tappan, everyone else was hot on Magic Chef, but I said, “The multiples on Magic Chef are too high. Where is it going to go from here? Magic Chef was at the top of its cycle and Tappan was at the bottom. That’s where I preferred to stake our claim.”*

At Kingsley’s suggestion Icahn started acquiring the stock in 1977 when it was selling for \$7.50 per share. He saw that Tappan, as a niche player in a market dominated by the likes of General Electric and Westinghouse, was an attractive candidate for strategic acquisition by one of those behemoths. With a book value of around \$20 per share, Icahn figured his potential upside was around \$12.50 per share, or about 170 percent. In what would become a typical Icahn analysis, he saw that the discount in the stock provided limited downside risk, and the potential for a significant gain if he could chum the waters enough to foment a takeover. Tappan made an ideal first target for his new strategy: If the coin fell heads, he would win big; if tails, he wouldn’t lose much.

Icahn built his position in Tappan through 1977 and then, in early January 1978, he and Kingsley placed a call to Tappan’s president, Donald Blasius, to alert him of their presence. Icahn told Blasius that he had acquired between 10,000 and 15,000 shares of Tappan and was considering making a “substantial additional investment.” Seemingly oblivious to Icahn’s overtures, Blasius noted in a subsequent memo to Dick Tappan, Tappan’s chairman, that Icahn “seemed pleased that we took the time to talk to them about the company.” In an effort to keep up the pressure, Icahn

and Kingsley called Blasius again in late February, by which time they had acquired 70,000 shares of Tappan stock, to let Blasius know that Icahn was interested in Tappan for its potential as a takeover candidate. As he had after the first call, Blasius dutifully sent a memo to Dick Tappan in which he noted that Icahn had told Blasius that he “had made a lot of money in buying low-priced stocks that were in the process of turnaround. In some cases, the turnaround improved the value of the stock, but in other cases a buy-out was completed which approximately doubled the stock price.” Blasius further noted that “they consider [Tappan] a good possibility for this occurring, which is added incentive for their investment.”<sup>12</sup>

Icahn continued to build his holding in Tappan stock to several hundred thousand shares—a sizeable position, but still too small to require him to file a *Schedule 13D* notice with the SEC. The Schedule 13D notice lets the market know the intentions of a shareholder who owns more than 5 percent of a company’s outstanding stock and who proposes to undertake some corporate action, including a takeover, liquidation, or other change-of-control event. Icahn had hoped that his continued purchases might alert others to the situation developing at Tappan, including risk arbitrageurs—investors who bet on the outcome of takeovers—other potential strategic acquirers, and their investment bankers. In the 1980s, risk arbitrageurs with a position in a stock would often turn a rumor about a takeover into a self-fulfilling prophecy. Unfortunately for Icahn, the explosion of takeover activity that followed in the 1980s hadn’t yet kicked off and, in the absence of a 13D filing that might draw attention to Tappan, the stock languished for the next nine months.

Icahn opted to take matters into his own hands, setting up a May 1978 lunch between Blasius and Fred Sullivan, the chairman of the conglomerate Walter Kidde & Co., who owned a large block of Tappan stock. Icahn hoped that Sullivan might want to bolt Tappan’s stove business onto its *Faberware* division. He had, however, neglected to mention to Blasius that anyone else would be at the lunch. Blasius was enraged when he discovered on the morning of the lunch that Sullivan would be attending and, further, that he was interested in acquiring Tappan. At the lunch, Blasius made it clear that the company was not for sale. Taken aback, Sullivan told Blasius and Icahn that he wouldn’t entertain a hostile takeover, so the acquisition was a non-starter. Blasius’s post-lunch memo noted that Sullivan “understood that we were not for sale and, therefore, would not go any further. Then he added without any suggestion on my part, ‘If anyone comes along that you are not interested in, or you would like to come to a friendly port, we would be very happy to talk to you.’”<sup>13</sup> If Blasius was relieved when he heard Sullivan say that he wouldn’t take the Tappan acquisition any further, Icahn heard that a Tappan acquisition was in the offing if he could



find a buyer prepared to proceed on a hostile basis. Blasius's memo also noted that "[Icahn] repeated that this was not an attempt to accomplish, or the beginning of a buy-out—that they felt the stock was undervalued at approximately \$8 and had good growth potential. He also indicated that we should not be worried if a [13D] were filed as it would not be intended as the beginning of a takeover attempt."<sup>14</sup>

Icahn stepped up his attempts to find a buyer for Tappan, but without success. He also continued buying Tappan stock. By late November 1978 Icahn's position was big enough that he was required to file a 13D with the SEC, and Wall Street finally got the news that Tappan was "in play." The stock surged and, in January 1979, Icahn let Blasius know that if the shares were to rise two or three more dollars he would be a seller. He also teased Blasius that an anonymous strategic acquirer had approached him to buy him out for between \$15 and \$17 per share. He reminded Blasius that Sullivan stood ready to serve as a "white knight," a friendly acquirer who might retain existing management. Icahn viewed his shareholding as being large enough to qualify him for a tenth seat on the board to be created just for him, and said as much to Blasius. Blasius rejected the request out of hand. In Blasius's memo to the board, he noted:<sup>15</sup>

*I explained that our board was limited to nine members with only two being representatives of management and that the number had been fixed by the board either last year or the year before. I also gave him an outline of the board strength that I felt was represented and that I really believe we have an efficient board match—independent, very capable and doing a good job and that I, personally, saw no need or desire to add a tenth member.*

The company, now fully apprehending the threat Icahn presented, moved to issue preferred stock in an effort to block any hostile interest. Icahn found out about the move along with the other shareholders. Said Kingsley, "We first learned of the serially preferred tactic through a proxy statement that came in the mail. As soon as I saw it I said, 'If we're going to do something, Carl, we had better do it now.'"<sup>16</sup> The risk, as Kingsley saw it, was that the preferred stock could be used to derail any hostile tender offer. If Icahn couldn't use his major shareholding as a catalyst to sell the company, much of his influence would be gone.

Icahn responded by launching a media campaign to defeat the preferred stock issue and have Tappan sold at full value. In the face of Icahn's towering indignation, the board folded almost immediately, agreeing to withdraw its proposal for the issue. Icahn pressed on regardless. In an April 1979 letter to Tappan shareholders he argued for a seat on

the board and the sale of the company at a substantial premium to the prevailing market price:<sup>17</sup>

*I am writing this letter to ask you to elect me to the Board of Directors at the Annual Meeting of Shareholders on April 23, 1979. As the largest shareholder of Tappan, I would like to see our company acquired or tendered for at a price close to its December 31, 1978, book value of \$20.18.*

Channeling Berle and Means, Icahn argued that management was insulated from Tappan's poor performance by their overly generous compensation package:<sup>18</sup>

*During the past five years Tappan, under its current management, has lost \$3.3 million on sales of \$1.3 billion and during the same period [Dick] Tappan and [Donald] Blasius, Tappan's Chairman of the Board and President, respectively, received salaries and bonuses totaling \$1,213,710.*

The letter contained a chart comparing Tappan's earnings and Dick Tappan and Blasius's salaries on an annual basis. Referring to the chart, Icahn said:<sup>19</sup>

*If I personally owned a business with these operating results and which had a substantial net worth, I would certainly seek to sell that business. I believe the same logic should apply in the case of Tappan.*

Taking advantage of any lingering doubts shareholders might hold about the motives of management, Icahn resurrected the specter of the withdrawn preferred stock issue. Saying that management had admitted that such an issue "might have the effect of discouraging some future attempt to take over the company by a cash tender offer or otherwise," Icahn pledged that, if elected to the board, he would "discourage any such future proposals in their embryonic stages."<sup>20</sup>

*As a director of Tappan my first act will be to recommend that we retain an investment banking firm (unaffiliated with me) to solicit proposals from third parties to acquire our company at a price near its book value, which at December 31, 1978, was \$20.18.*

*Although management has stated to me that they do not desire the acquisition of Tappan by another company, I assure you that, if I am elected, I will inform would-be suitors that at least one*

*member of the Board does not share management's views with respect to the acquisition of Tappan by another company. I will attempt to see to it that shareholders are made aware of any indications of interest or actual offers to acquire our company, which are received from third parties.*

The letter had the desired impact, and Icahn won his seat on the board.

As a director, he moved quickly to sell Tappan's assets. At the first board meeting he pushed for the liquidation of the company's money-losing Canadian subsidiary, Tappan-Gurney, which owned valuable real estate in Montreal, and for the sale of Tappan's Anaheim, California, factory. He also pressed on for the sale of the entire company, shopping Tappan to leveraged buy-out firms and strategic acquirers. Recognizing that Icahn had won, and would shortly find a buyer, management moved to find their own white knight. Tappan and Blasius met with the giant Swedish appliance maker AB Electrolux and offered Tappan up on a platter. Electrolux bit, bidding \$18 per share. The bid delivered a \$2.7 million profit on Icahn's 321,500 shares, representing an almost 90 percent gain on his \$9.60 per share average purchase price.

In a surprising move, Dick Tappan was so impressed with Icahn's strategy that he subsequently became an investor in Icahn's partnership:<sup>21</sup>

*We held a final board meeting, at which time the directors approved the company's sale to Electrolux. Icahn attended that meeting and sometime during the course of the evening I said, 'Icahn has done us a favor. We got a 50 percent premium over the company's market value, and Electrolux is going to make capital investments in Tappan.' I said, 'If you have any deals you want to cut me in on—' That's when Icahn said, 'Yes, I have one going on now.'*

And so Dick Tappan became a limited partner, investing \$100,000 in the Carl C. Icahn Partnership. It would prove to be a great investment for the former chairman.

Tappan would become the template for Icahn's later sorties. In Tappan, the theory outlined in the *Icahn Manifesto* had been proven correct in stunning fashion: Acquire a shareholding in a deeply undervalued company sufficiently large to influence management; draw the market's attention to the wide discount between market price and intrinsic value; and push management for a catalyst, like a sale of the company, a liquidation, or some other value-enhancing act. If management remained intransigent and the proxy contest didn't draw the attention of other bidders, Icahn could move to put the company in play by making a tender offer, which put him in a win/win

position. On one hand, it created a price floor in the stock. Icahn could then wait to see if other financial or strategic buyers stepped in with a higher bid to create a liquidity event for his position. If no other bidder emerged, Icahn could take the company private himself, providing liquidity to the other shareholders, and, presumably, getting it for cheap after demonstrating that no other bidder wanted such a moribund business. It was value investing in which the investor controlled his own destiny, and, as Icahn's experience in Tappan and other early campaigns documented in a later Icahn partnership memorandum demonstrated, it worked:<sup>22</sup>

**TABLE 1.1** Icahn Partnership Memo: "Stock Prices During Unfriendly Maneuvers"

| Target Company    | Three Months Prior to Attempt at Target (\$) | High After Attempt (\$) |
|-------------------|--|-------------------------|
| Warner Swasey     | 29   | 80                      |
| National Airlines | 15   | 50                      |
| Wylain            | 13   | 28½                     |
| Flintkote         | 30   | 55                      |
| Fairchild Camera  | 29   | 66                      |
| Tappan            | 8  | 18                      |

## **GRAHAMITE PROTO-ACTIVISM**

What drew Icahn to Tappan? What did Kingsley see that others had missed? The stock had been savaged after it had posted its first loss in 40 years, the new business seemed to be a loser, and it was a tiny player in a market led by General Electric and Westinghouse, behemoths both. To understand Tappan and the strategy outlined by Icahn and Kingsley in the *Icahn Manifesto* that they used to such powerful effect, we need to begin with the great value investor and investment philosopher Benjamin Graham. Icahn and Kingsley owed an intellectual debt to Graham, whose own investment strategy was quite different from one that might be suggested by his *Dean of Wall Street* sobriquet, more red-in-tooth-and-claw than professorial or academic. Graham was a forceful and eloquent advocate for the use of shareholder activism to foment change in deeply undervalued companies. The very first edition of his magnum opus, *Security Analysis*, published in 1934, devoted an entire chapter to the relationship between shareholders and management, which Graham described as "one of the strangest phenomena of American finance."<sup>23</sup> "Why is it," he wondered, "that no matter how poor a corporation's prospects may seem, its owners permit it to remain in business until its

resources are exhausted?” In answering his question, Graham wrote that it was a “notorious fact . . . that the typical American stockholder is the most docile and apathetic animal in captivity:”<sup>24</sup>

*He does what the board of directors tell him to do and rarely thinks of asserting his individual rights as owner of the business and employer of its paid officers. The result is that the effective control of many, perhaps most, large American corporations is exercised not by those who together own a majority of the stock but by a small group known as “the management.”*

He saw deep undervaluation as a prod impelling shareholders to “raise the question whether it is in their interest to continue the business,” and “management to take all proper steps to correct the obvious disparity between market quotation and intrinsic value, including a reconsideration of its own policies and a frank justification to the stockholders of its decision to continue the business.”<sup>25</sup>

Graham published *Security Analysis* just two years after Berle and Means, who had identified the principal-agent problem in public corporations, released their work. He cited Berle and Means’s work with some agitation. They had submitted that it was “apparent to any thoughtful observer” that the effect of the separation of ownership and control was that the corporation had ceased to be a “private business device” and had become a public “institution:”<sup>26</sup>

*[The] owners of passive property, by surrendering control and responsibility over the active property, have surrendered the right that the corporation should be operated in their sole interest—they have released the community from the obligation to protect them to the full extent implied in the doctrine of strict property rights. At the same time, the controlling groups, by means of the extension of corporate powers, have in their own interest broken the bars of tradition which require that the corporation be operated solely for the benefit of the owners of passive property.*

Graham rejected Berle and Means’ argument that a corporation be regarded as something like community property that “serve not only the owners or the control group but all society.” He doubted that the shareholders had intentionally “surrendered the right that the corporation should be operated in their sole interest,”<sup>27</sup> contending that the American stockholder had abdicated by default. Graham’s view was “that corporations are the mere creatures and property of the stockholders who own them; that the officers

are only the paid employees of the stockholders; and that the directors, however chosen, are virtually trustees, whose legal duty it is to act solely on behalf of the owners of the business.”<sup>28</sup> All that was required to reverse course was to “reassert the rights of control which inhere in ownership.”<sup>29</sup>

It was no coincidence that the discussion on shareholder rights in *Security Analysis* followed on the heels of the chapter on calculating liquidation value, the dourest assessment of a company’s prospects. Liquidation value is the residue remaining after all of a company’s liabilities have been satisfied and the company has been wound up. Graham described it as simply “the money which the owners could get out of it if they wanted to give it up.”<sup>30</sup> To Graham, a stock price below liquidation value was clear evidence that the company’s management was pursuing a “mistaken policy,” and should take “corrective action, if not voluntarily, then under pressure from stockholders.”<sup>31</sup>

*In its simplest terms the question comes down to this: Are these managements wrong or is the market wrong? Are these low prices merely the product of unreasoning fear, or do they convey a stern warning to liquidate while there is yet time?”*

In 1932—two years before the publication of *Security Analysis*—Graham authored a series of articles for *Forbes* magazine highlighting the large number of stocks that continued to trade well below liquidation value fully three years after the 1929 stock market crash. The solution, proposed Graham, was that investors become “ownership conscious.”<sup>32</sup>

*If they realized their rights as business owners, we would not have before us the insane spectacle of treasuries bloated with cash and their proprietors in a wild scramble to give away their interest on any terms they can get. Perhaps the corporation itself buys back the shares they throw on the market, and by a final touch of irony, we see the stockholders’ pitifully inadequate payment made to them with their own cash.*

Graham practiced what he preached. The employees of Graham-Newman, his investment partnership, spent their days poring through the 10,000 pages in the *Standard and Poor’s* or *Moody’s Manuals* looking for net nets. Among them was a future star who Graham had been initially reluctant to take on, the young Warren Buffett. Graham’s philosophy was also eagerly embraced by a clutch of investors in the 1940s, 1950s, and 1960s, including Thomas Mellon Evans, Louis Wolfson, and Leopold Silberstein—the so-called *White Sharks of Wall Street*<sup>33</sup>—who rose to prominence using

proxy contests and media campaigns to unseat entrenched managements. Evans was the prime mover of his day, taking Graham's liquidation value analysis and using it to wreak havoc on the gray flannel suits of the 1940s and 1950s. He waged numerous takeover battles using tactics that are forerunners of those employed by many of the modern-day activists. Born September 8, 1910, in Pittsburgh and orphaned at the age of 11, Evans grew up poor. Despite his famous middle name—his grandmother's first cousin was Andrew Mellon, the industrialist and Secretary of the Treasury under Presidents Harding, Coolidge, and Hoover—he began his financial career at the bottom. After graduating from Yale University in 1931 in the teeth of the Great Depression, he landed a \$100-a-month clerk job at Gulf Oil. While his friends headed out in the evening, Evans would stay home reading financial statements and looking for promising companies, those he could buy for less than liquidation value.

In *Security Analysis* Graham had outlined a clever short cut to calculating liquidation value, which examined a company's working capital as a rough, but usually conservative, proxy for the liquidation value. Graham called this calculation the *net current asset* value. Employing Graham's technique, Evans found stocks selling for less than liquidation value by calculating their net quick assets, another name for the most liquid portion of Graham's net current asset value. His friends teased him about his obsession, so much so that they gave him the nickname "Net Quick" Evans.<sup>34</sup> In 1939 Evans got control of the dilapidated H. K. Porter Co., a builder of industrial locomotives, by buying its distressed bonds at 10 to 15 cents on the dollar. He reorganized the company, converting his bonds into equity, and became president at age 28. From then on, "Net Quick" Evans was the "slick-haired, aggressive"<sup>35</sup> terror of the sleepy boardrooms of the era, much like the stereotype of the corporate raiders in the 1980s.

Even Warren Buffett, Graham's most apt student, tried his hand as a liquidator, briefly turning to Graham-style shareholder activism in his own investment partnership. He obtained control of Dempster Mill Manufacturing Company<sup>36</sup> in the early 1960s through a majority shareholding and board seat before almost completely liquidating it. In the process he incurred the wrath of the town of Beatrice, Nebraska, when he proposed to liquidate the plant there. After a vitriolic campaign waged by the townsfolk and supported by the local paper, Buffett eventually sold Dempster at book value—its almost wholly liquidated assets consisting of just cash, marketable securities, and the plant in Beatrice—to the founder's grandson and his investor group. While it was a typically profitable investment for Buffett, he was scarred by the animosity directed at him, and vowed never to do it again.<sup>37</sup>

Like Graham, Icahn had no such qualms. Icahn's biographer Mark Stevens, describing his rapid ascent from discount options broker to

“formidable raider and financial tactician,” said that Icahn “combined an extraordinary intellect with a battering-ram personality to exploit a glaring weakness in the American corporate establishment, earning enormous sums as he attacked the likes of Tappan.” At the zenith of his influence in the 1980s, he controlled billions in capital and his reach extended to the giants of the public markets, including Texaco, the “Big Red Star of the American Highway” for which he bid \$12.4 billion, and U.S. Steel, the world’s first billion-dollar corporation, then sporting a market capitalization of \$6 billion. Other investors took notice, and a cottage industry of so-called corporate raiders sprang up. For a brief period, news of their exploits would extend beyond the business pages and into popular culture, most notably in Michael Douglas’s character Gordon Gecko in *Wall Street* (1987), Richard Gere’s Edward Lewis in *Pretty Woman* (1990), and Danny DeVito’s Larry “The Liquidator” Garfield in *Other People’s Money* (1991), notable for a memorable scene in which DeVito draws Graham’s net current asset value formula on a blackboard. Their influence waxed and waned with the market. Following the 1987 stock market crash, they gradually retreated again from the public consciousness.

A new breed of activist investors emerged in the wake of the dot-com bust in the early 2000s, chasing the cashed-up failures of the information technology and communications boom. As Evans and Icahn had before them, the new activist investors rediscovered the power of the public media campaign, the proxy contest, and the tender offer. The new activists moved in some cases to civilize shareholder activism, allowing institutionalization that attracted new capital, and rendered countless new innovations, from web-based campaigns and “public” private equity. Others resisted civilization and institutionalization, maintaining the freebooting ways and anti-glamour machismo of their corporate raider forebears. Perhaps it is a necessary response to the goings on in the stocks found in the netherworld of the market. Far from the glare of analysts and the media, blatant fraud, outright theft, and flagrant oppression of minority investors flourishes. The sheriffs on this frontier are the activists and short sellers, and who can blame them if *the horror, the horror* drives them to write Hunter S. Thompson *Gonzo*-style poison-pen letters, drafted as if Mistah Kurtz had to file his “Exterminate all the brutes!” pamphlet with the SEC.

Icahn’s evolution from liquidator to corporate raider reflected the underlying philosophical shift in the broader world of value investment and shareholder activism. Graham’s approach, which identified targets by their discount to liquidation value, was appropriate to the time and extremely effective, but those opportunities had largely disappeared from the investment landscape by the 1980s. In response, modern activists have adapted, employing a wider lens to assess value and exploiting a broader array of



tools to achieve their ends. Icahn took his place alongside them, bigger and better capitalized than ever, and, as he had in the 1980s, he would straddle the most recent epoch of shareholder activism and stand again at the forefront of large capitalization shareholder activism in the 2000s.

## Notes

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