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Daniel Loeb and Hedge Fund Activism: The Shame Game

"It seems that Star Gas can only serve as your personal 'honey pot' from which to extract salary for yourself and family members, fees for your cronies and to insulate you from the numerous lawsuits that you personally face due to your prior alleged fabrications, misstatements and broken promises."

—DANIEL LOEB, 2005

IN SEPTEMBER 2013, BILLIONAIRE investor Ron Burkle amended his Schedule 13D statement regarding his firm's investment in a company called Morgans Hotel Group. The 13D is a form filed with the Securities and Exchange Commission—and made publicly available through the SEC's website—that requires 5% shareholders of public companies to, among other things, report recent activity in the stock, their sources of capital, and the purpose of the transaction. Burkle's amendment, his tenth such filing in Morgans since late 2009, included boilerplate passages filled with words like *hereby* and phrases like "such reduction is not determinable." But the purpose of Burkle's filing was not to update the data on his 13D. He reported no change in his holdings or the sources of his funds.[1] Instead, Burkle amended the filing to include a letter he had written a few days earlier to Morgans Hotel's chairman and CEO. He wrote, "Stop acting like a spoiled child. Stop playing with the company as though it's your new toy. Get Morgans on the market and sell it to an appropriate buyer. It's time to sell now for all stockholders benefit. Ask your mother to buy you something else."[2]

When the hostile raider era ended in the late 1980s, management teams of public companies retrenched behind their poison pills and

anti-takeover laws like Delaware Section 203. But they did not have free rein. Large institutional investors like CalPERS and TIAA-CREF were more attuned to corporate governance issues, and much less tolerant of underperforming managers. What's more, a group of reformers, opportunists, and gunslingers—a new generation of Benjamin Grahams and Louis Wolfsons and Carl Icahns—emerged in the form of scrappy hedge fund managers with tactics reminiscent of the Proxyteers. What they lacked in capital they made up for with determination and audacity. When they did not have the leverage to influence a management team, they resorted to strongly worded public shamings to try to get their way. One of their best weapons was the pen, and they used the 13D to air their grievances to the rest of the market and win the support of other shareholders. Their methods turned out to be powerful, driving business headlines and shaking up the executive suites of some of America's most iconic companies. Even superstar corporate raiders like Carl Icahn and Nelson Peltz would soon join their ranks.

Hedge fund is a vestigial term that *Fortune* magazine's Carol Loomis used in 1966 to describe A. W. Jones's long-short "hedged" investment partnership. It now applies to a variety of private investment funds that charge their investors an incentive fee carved out of the fund's profits, in addition to a fee based on assets under management. While their investment strategies vary widely, hedge funds tend to share a similar legal structure and a low (but rapidly rising) level of regulatory oversight. Partnerships run by Benjamin Graham, Robert Young, Warren Buffett, and Charlie Munger would today be called hedge funds. In 1990, they occupied a tiny niche in the money management industry. There were only about 600 hedge funds, with a combined $39 billion in assets.[3] Today they number over 15,000 and manage over $3 trillion.

Before the industry matured, hedge funds attracted mostly independent-minded traders and investors with an entrepreneurial streak. Most of them started with very little capital and had to generate good performance to make ends meet. Paul Tudor Jones founded Tudor Futures Fund in 1984 with $1.5 million.[4] Daniel Loeb's Third Point began with $3 million in 1995, and David Einhorn's Greenlight Capital launched with $900,000 in 1996. Though each of these funds went on

to manage billions, they started life as small fry. Back in the mid-1960s, Warren Buffett explained to his investors that his "willingness and financial ability" to assume control of his portfolio companies gave him a valuable "insurance policy."[5] But if you only manage a small pool of capital and Michael Milken happens to be banned from the securities industry, what can you do to exert meaningful pressure on a public company? How can a young hedge fund get a management team's attention without an Icahn-style tender offer in its back pocket?

A Radiating Weapon

On May 18, 1999, a young hedge fund manager named Robert Chapman wrote a bear hug letter to Corporate Renaissance Group (CRG), a business development company run by Martin D. Sass. The company traded at a steep discount to its assets, which consisted of only cash and three investments. After buying back what shares it could on the open market, CRG announced that it would pursue strategic alternatives including buying an operating business or liquidating the company. When it failed to find a good acquisition candidate, the management team, led by Sass, offered to take the company private for $8 per share.

Chapman owned 6% of CRG, and he thought its cash and investments were worth at least $10 per share. The company's board appointed a special committee to evaluate the management bid, but Chapman worried it would be biased in favor of Sass, who was chairman, CEO, and the largest shareholder. To keep the special committee honest, Chapman submitted a $9 bid while arguing that a liquidation was in shareholders' best interests. He even added his own "highly confident" language. He didn't have the money himself, but he was "highly confident that current discussions regarding financing will prove successful."[6] This wasn't as convincing as a letter from Drexel Burnham, but it sounded impressive. Chapman attached his bear hug as an exhibit to a 13D filing, much as a corporate raider would have done in the 1980s. The gambit worked. After announcing that the value of its assets had increased to more than $12 per share, CRG commenced a liquidation.

Five months later, Chapman attached another letter to one of his public 13D filings. He wrote to the chairman of Riscorp, a collapsed workers' compensation insurance company, four days after the death of its CEO. Riscorp had employed the CEO through a contract with Phoenix Management, which he ran with a younger partner, Riscorp's general counsel. Upon his death, Riscorp continued the relationship with Phoenix, and the younger partner assumed the CEO's duties. Chapman argued that Phoenix was already grossly overpaid, and that the younger partner was not nearly as qualified as the deceased CEO. He added, "I would be remiss not to mention that it was during his role as a legal officer . . . that the company became embroiled in one of the worst legal scandals ever seen by the insurance industry. . . ."[7]

This time, Chapman did not make a formal buyout proposal. He was merely pushing the company to terminate its expensive management agreement with Phoenix. But it was a delicate argument to make—on the one hand, arguing that the CEO was overpaid while, on the other, expressing sympathy for his recent passing. At more than fourteen hundred words, the letter was thorough and well written. Chapman did not have enough shares to vote the directors out of office, but with his creative use of Schedule 13D, he'd found a way to pressure them in full view of the shareholders.

With Robert Chapman's next 13D, the revolution was born. On March 30, 2000, he wrote a letter to J. Michael Wilson, the chairman and CEO of American Community Properties Trust (ACPT). He attacked the Wilson family, which owned 51% of the stock, for plundering the company through related-party transactions and a "consulting-fee gravy train." Chapman added, "If the Trustees desire to continue running ACPT as a real-life version of Monopoly whereby a 32-year old graduate of Manhattan College in the Bronx and former bank loan administrator is named CEO by his father, then I strongly suggest you take the company private, wherein underserved, nepotistic practices are not scrutinized."[8]

Chapman's letters were snarky and irreverent, often combining astute financial analysis with vitriol and humor. He explained his strategy to a Bloomberg reporter: "Ridicule is a radiating weapon."[9] He would end up filing 13Ds on seventeen companies. Some of the letters

were outrageous—the term "skin flute" was used once—but he made money on every investment, generating 20% annualized returns on all but one.[10]

Robert Chapman stepped back from the hedge fund industry in 2003 after fracturing his spine bodysurfing. He left just as hedge fund activism kicked into overdrive. A new generation of activist hedge fund managers, wielding 13D letters that sounded like they were written by potty-mouthed teenagers rather than Warren Buffett or Benjamin Graham, began targeting underperforming companies. None did it better than Daniel Loeb from Third Point. As Dan Loeb and his kindred spirits at funds such as Pershing Square, Jana, Ramius and Starboard Value, Greenlight, and ValueAct evolved from gadflies to raptors, they began waging major proxy fights, winning support from large institutional investors, and leading the debate on major corporate governance issues.

The Paddle Out

Daniel Loeb's early years did little to suggest he would become a titan of industry. He graduated from Columbia with a bachelor's degree in economics, but he was not a star student as Benjamin Graham or Carl Icahn had been. He did share one formative experience with Icahn: In his early twenties he made a ton of money speculating in the stock market and then lost everything plus a little more in tax liability. It would take Loeb a decade to pay back his father, who bailed him out of the mess. He told a Bloomberg reporter, "That was a 10-year lesson in the perils of leverage and overconcentrating positions."[11]

After college, Loeb bounced around various jobs in finance, several on the buy side followed by a few on the sell side.[12] In the late eighties, he even worked a brief stint at Chris Blackwell's Island Records. The company had recently suffered a liquidity crisis after sinking so much money into a crime-thriller movie starring Art Garfunkel that it could not pay U2's royalties. Loeb helped Blackwell secure debt financing and resolve a dispute with Bob Marley's estate.[13] Island was one of the great record companies of all time, and an early lesson in hidden value. Though it constantly flirted with liquidity problems and financial

trouble, it was an immensely valuable company. When Blackwell sold to Polygram in 1989 for $300 million, U2, which had converted its royalty receivable into an equity stake, made a killing.

After Island, Loeb worked for three years as a risk-arbitrage analyst at a hedge fund called Lafer Equity Investors. When he couldn't get another hedge fund job after Lafer, he transitioned to the sell side. For many an inspiring investor, moving from a hedge fund to the sell side is a plank walk that leaves you permanently off the ship. But Loeb landed in the right place at the right time—the Jefferies distressed trading desk in 1991.

Jefferies Group was a Los Angeles-based brokerage that built a franchise doing large, off-exchange block equity trades. The firm ran into trouble in the mid-1980s when Ivan Boesky, cooperating with federal investigators, got founder Boyd Jefferies to discuss a stock-parking arrangement on a recorded phone call. The insider trading crackdown threatened the firm's viability, but ultimately boosted its fortunes. Boyd sacrificed himself to save his company, and when Drexel later crumbled, Jefferies Group was there to pick up the pieces.[14]

After Drexel filed for bankruptcy in 1990, Jefferies hired dozens of its people and expanded the brokerage into high-yield and distressed debt. Drexel provided talent for Jefferies's sales and trading desks, which then traded Drexel-issued bonds. Dan Loeb was a distressed analyst and trader, learning how to navigate the bankruptcy code by researching bankrupt Drexel issuers. Having already done so much for Jefferies and Loeb, it seemed like Drexel had nothing left to offer. But there was one last morsel. Loeb began to look at the Drexel bankruptcy itself, and found an obscure security entitled to payments from Drexel's liquidating trust.

Drexel's liquidation plan formed three tranches of "certificates of beneficial interest" (CBIs) for claimants. According to projections in the bankruptcy's disclosure statement, the senior tranche, CBI-A, would receive $646 in payments per unit—more than a billion dollars in total.[15] Many of the CBI-A holders were large European banks that had already written off their Drexel claims. Loeb got a list of owners from the bankruptcy court and found that they were willing sellers at bargain prices. He lined up his best customers to buy the CBI-As, and they were

rewarded with a bonanza. Drexel's liquidation ultimately paid out more than $2 billion to creditors.[16]

Loeb did very well at Jefferies and established valuable relationships with a group of rising investors that would come to dominate the hedge fund industry. He also found himself near the epicenter of distressed-debt investing right as it emerged into a viable asset class—a result of the early 1990s recession. After a year selling bonds at Citicorp, Dan Loeb finally started his own hedge fund. In 1995, he launched Third Point from the weight room in fund manager David Tepper's New Jersey offices.[17]

Why Am I Mr. Pink?

Investing communities have always benefited from a healthy exchange of ideas among peers. Robert Beverley, one of the richest men in early America, frequently wrote to a group of buddies who invested in banks and insurers in northern Virginia around the turn of the nineteenth century. They shared notes on the companies' finances, their underwriting and loan quality, as well as their governance and levels of insider ownership.[18] Benjamin Graham nurtured long relationships with like-minded investors, such as Bob Marony, the financial officer of a railroad that Graham savaged in a research report he wrote for his first job. Marony would later cosign Graham's first letter to the Rockefeller Foundation about the pipeline companies. Warren Buffett organized retreats for the Grahamites to caucus with their former teacher. Walter Schloss had decades-long pen pal relationships with fellow stock enthusiasts. Michael Milken supposedly talked to five hundred people on the phone a day.[19] One of them was Ivan Boesky, whose idea exchanges were much more illicit and sometimes involved briefcases stuffed with money.

My point is, there have been very few lone wolves in the investment world.

Part of the education requires discussing your ideas and investment process with others rather than just sprinting onto the battlefield alone. Today, investors swap thoughts on Twitter. Maybe tomorrow they'll strap on a virtual reality headset and chat with AI bots programmed to look and think like Warren Buffett. In the early days of Daniel Loeb's

Third Point, they posted stock recommendations on anonymous Internet message boards.

"Mr. Pink shares his wisdom on such diverse topics as spin-offs, mutual thrift and insurance conversions, merger arbitrage, post-bankruptcy equities and short ideas. Mr. Pink does not lie." In 1996, Loeb appeared as "Mr. Pink" on Siliconinvestor.com and started posting on boards for stocks he had shorted. The next year he launched his own board there, "Mr. Pink's Picks," in which he shared his ideas, long and short, and engaged with anyone who happened by. "Oh Lord He is Wise!" Mr. Pink would proclaim when one of his ideas worked. "Oh Lord He Sucks!" when they didn't. In 1997, he wrote, "Mr. Pink is a pip squeak in the world of hedge funds." It was a curious time in the early days of stock message boards, when investors like Dan Loeb and Michael Burry (profiled in Michael Lewis's *The Big Short*) passed out tips to anybody who would listen. The level of discourse was surprisingly high, as was the quality of the recommendations. Loeb pitched a lot of "special situations"—insurance company demutualizations, spin-offs, broken IPOs, and distressed equities—at a time when they were often grossly undervalued. Reading Mr. Pink's board now would make any investor in today's competitive markets wistful for layups past.

Third Point's early performance was excellent. Loeb did well on both his long and short positions, and by early 2000 his fund had grown to more than $130 million.[20] In five years of buying small capitalization companies, as well as selling them short, Dan Loeb learned just how terrible their governance was. He'd seen long positions blow up because of bad management. He'd also had short targets squander what little money they had left by suing him. When he read Chapman's 13D letter to ACPT, Loeb knew he'd found a useful weapon for his emerging fund. Years of posting strident messages as Mr. Pink informed Dan Loeb's interface with the rest of the market. His 13D letters would read more like targeted flames on anonymous message boards than formal business correspondences.

ON SEPTEMBER 8, 2000, Loeb filed a 13D on Agribrands, a recent spin-off from Ralston Purina. The company had announced plans to merge

with Ralcorp, another Ralston Purina spin-off, on terms that Loeb believed shortchanged Agribrands' shareholders. The chairman of both companies was Bill Stiritz, who had been Ralston Purina's CEO since 1981. Stiritz was a well-respected businessman who had created a lot of value for Ralston Purina shareholders during his tenure. He dismantled what was once a bloated conglomerate, kept the best businesses, leveraged them, and then used excess cash to repurchase shares. Once he'd accomplished that, he began to spin off Ralston Purina's constituent parts to shareholders.[21] Ralcorp and Agribrands came out in 1994 and 1998, respectively.

Loeb argued that the deal, which the market valued at about $41 per share, grossly undervalued Agribrands. He then accused Stiritz of once before putting his own interest before Agribrands' shareholders. Though the stock had been "basically flat" since its spinoff—it rose from $35 ¾ after the spin to $36 ¼ over two years later, just before the merger announcement—Loeb pointed out that Stiritz was given a mammoth 500,000-share options grant in 1998 when the Asian crisis briefly pushed the stock down to $21. According to Loeb, this happened right before the company announced a large share repurchase and a quarter that beat analyst expectations.

Loeb quoted Stiritz saying the spin-offs had been "successful." He wrote, "But by whose measure? In my business, fund management, we are measured by the rate of return earned for our investors. (Our returns have been quite good, averaging over 35% per annum for over five years notwithstanding the drag from our investment in Agribrands.) From such an investor's perspective the performance of Agribrands and Ralcorp has been dismal. The propitious timing and pricing of your option grants have yielded you a profit of over $14.0 million. It would appear that the success you speak of is your profits on your options, not that of your shareholders."[22]

With his very first 13D, Loeb showed that he was not afraid to disrespect the village elders. Chapman's 13D letters often targeted mediocrities that nobody had ever heard of. But accusing someone like Bill Stiritz of self-dealing was different. Stiritz was an experienced capital allocator who saw an opportunity to fold Agribrands, a mature animal feed

business with excess cash, into Ralcorp, a higher-return consumer products company that wanted to grow by acquisition. There were no synergies to speak of, but he thought he'd found a way to put Agribrands' capital to better use for its shareholders. Loeb, of course, disagreed. He thought the deal harmed Agribrands' shareholders by undervaluing its core business. Three weeks after his 13D, Cargill made an unsolicited written offer to acquire Agribrands for $50 per share in cash.[23] Cargill ultimately paid $54.50, and Loeb walked away with a huge profit.

OVER THE NEXT few years, Loeb filed a succession of angry 13D letters that, in addition to skewering CEOs for poor performance, were unafraid to target board members. One of Loeb's specialties was exposing directors who padded their professional experience as listed in company proxy statements. He outed several directors whose sole employment was at companies that were essentially empty shells. In a 13D letter to Penn Virginia, Loeb questioned the business experience of a board member who was "Founder and CEO" of "Woodforde Management, Inc," a "holding company."[24] Loeb discovered that Woodforde had no other employees and almost no revenues. The only business the director engaged in was an ailing detergent company, called Cot'nWash, run out of the same address as Woodforde. When Loeb addressed the shortcomings of a different Penn Virginia director later in the letter, he began, "We have placed an order for Cot'nWash that should come in handy for washing certain articles of clothing soiled when learning that the Company's newest Director . . ."

Loeb also gave a lot of attention to self-dealing and nepotism. In a letter to the chairman and CEO of InterCept, Loeb complained about an onerous related-party financing transaction as well as a leasing arrangement for a private jet. He also pointed out that the CEO's daughter and her husband were both on the company payroll, making nearly a quarter of a million dollars in combined salary. When Loeb called the CEO's son-in-law during work hours to learn about his role at the company, he was "on the golf course."[25] In a subsequent letter to InterCept, Loeb responded to the CEO calling Third Point a "sleazy hedge fund": "For someone who acquired iBill, a purported 'merchant processing

business' whose real activity is primarily to provide billing services to hard core pornographic websites, your credibility as moral arbiter is not strong. . . . [C]alling your second largest shareholder 'sleazy' in the media is further evidence of your poor judgment and exemplifies the type of behavior that should provide you with ample opportunity to join your son-in-law on the golf course in the not too distant future."[26]

What's notable about some of these personal attacks is that they often weren't that relevant to Loeb's investment, or his motivations for going active in the first place. The second letter to InterCept, for example, served no purpose but to taunt the CEO. It opened by stating, "I am writing to inform you that we agree with the market's determination that InterCept, Inc. (the 'Company') should be worth substantially more with your imminent involuntary extraction from the position of Chief Executive Officer, which we would expect to result from the likely sale of the Company." Loeb was not trying to lobby other shareholders to support him, nor was he hoping to persuade management or the board to do anything different. He was simply kicking the CEO when he was already on the ground. His letter to Star Gas Partners the following year was even harsher. But this time Loeb at least had a purpose: He wanted the chairman and CEO to resign. "Sometimes a town hanging is useful to establish my reputation for future dealings with unscrupulous CEOs," he explained.[27]

A Conservative, Dividend-Paying Stock

Star Gas Partners was a propane and heating oil distributor run by Irik Sevin, a former investment banker who had grown the company rapidly through acquisitions. Star Gas's game was not too dissimilar from the conglomerators'—it used its richly valued stock to help fund acquisitions.[28] But Star Gas did not rely on institutional investors chasing earnings growth to bid up its stock. It used a seemingly rock-solid dividend to seduce income-seeking retail investors into levitating its shares. Taking a page from the corporate raiders' playbook, Star Gas was also not afraid to leverage itself to the hilt.

From its very inception, Star Gas promised investors a healthy

dividend of more than $2.00 per share. The stock traded "on yield" as if it were a utility company, and the shares reached the mid-$20 range. But the heating oil and propane distribution business is not a stable utility. It's a seasonal, volatile business with high working capital requirements. In addition, heating oil is in secular decline as a home heating fuel, as homeowners gradually transition to natural gas heat. Star Gas issued shares *every* year between 1998 and 2004 to raise capital. The $335 million in dividends it paid over that period gave the appearance of operating stability, but the company generated $468 million by issuing stock.

In 2002, Star Gas embarked on an extensive restructuring of its heating oil operations. Heating oil delivery seems very similar to propane distribution, but the two businesses differ in fundamental ways. With propane, 95% of homeowners lease their tanks directly from the distributor, and most states only let the tank owners refill them. These "fire safety regulations" entrench incumbent dealers and make their customers essentially captive. With heating oil, customers can switch dealers with relative ease, making it a much more competitive, service-oriented industry. But there's a secret to the heating oil business: If it is operated well, it can generate excellent returns on capital. Some homeowners will always shop around for the best deal, but you can win the lasting loyalty of others with great, personalized service. Many small-town heating oil companies in the northeastern United States have made their family owners very wealthy by doing just that.

In an ambitious attempt to cut costs and improve service, Star Gas decided to deregionalize its heating oil business. It consolidated its operations under just two brands, thus eliminating ninety others it had acquired, many of which were family names that had served local communities for generations.[29] And rather than give customers full service from the twenty-seven local offices it owned, Star Gas dispatched service technicians from only two sites, managed oil delivery from eleven, and started using an outsourced call center in Canada.

Irik Sevin called his plan to create a large, efficient heating oil business in the image of a well-run propane company "very academic and intellectually interesting."[30] But the reorganization was a disaster. It cost almost $30 million without generating meaningful savings. As

you might expect, it also alienated customers, who left in droves. Net customer losses in 2004 were five times higher than they had averaged over the previous three years. To exacerbate Star Gas's woes, heating oil prices were rocketing up. The wholesale cost of home heating oil went from $0.78 per gallon in September 2003 to $1.39 in September 2004. This not only affected Star Gas's customers, who consumed less oil; it also threatened the company's liquidity as its working capital requirements increased. As the noose tightened around its neck in 2004, Star Gas made several operating decisions that amounted to taking a directional bet on the price of oil. It delayed hedges and price increases with hopes that heating oil prices might stabilize. Instead, they kept rising, and Star Gas suffered $8 million in unnecessary losses.[31]

On October 18, 2004, Star Gas suspended its dividend to preserve capital. The stock fell 80% in one day. In mid-November, the company sold its propane business for $481 million. Though Star Gas immediately used $311 million to pay down debt, its struggling heating oil operation remained dangerously overleveraged. To make matters worse, because the company was a publicly traded partnership, it passed through a huge taxable gain on its propane sale to shareholders. If you were a retiree who owned Star Gas because it had dependably paid $2.30 in annual distributions for the past five years, you were now stuck with a $5 stock that cost you $20, plus up to an $11 per-share taxable gain. Oof.

On February 14, 2005, Daniel Loeb sent a brutal Valentine's Day letter to Irik Sevin at Star Gas Partners (page 000). He opens by criticizing Sevin for not communicating with shareholders since the collapse of the stock. Loeb then writes, "Sadly, your ineptitude is not limited to your failure to communicate with bond and unit holders. A review of your record reveals years of value destruction and strategic blunders which have led us to dub you one of the most dangerous and incompetent executives in America. (I was amused to learn, in the course of our investigation, that at Cornell University there is an 'Irik Sevin Scholarship.' One can only pity the poor student who suffers the indignity of attaching your name to his academic record.)"

Loeb's letter includes a withering assault on Star Gas's operating performance, Irik Sevin's compensation, and the enormous amount of legal

and banking fees the company had incurred. Loeb estimates that the company spent $75 million in fees, or almost half its entire market capitalization. He then questions Sevin's seventy-eight-year-old mother's role as a director: "We further wonder under what theory of corporate governance does one's mom sit on a Company board. Should you be found derelict in the performance of your executive duties, as we believe is the case, we do not believe your mom is the right person to fire you from your job. We are concerned that you have placed your greed and desire to supplement your family income—through the director's fees of $27,000 and your mom's $199,000 base salary—ahead of the interests of unitholders. We insist that your mom resign immediately from the Company's board of directors."

Loeb concludes his letter by letting it slip that the two men know each other socially. He writes, "I have known you personally for many years and thus what I am about to say may seem harsh, but is said with some authority. It is time for you to step down from your role as CEO and director so that you can do what you do best: retreat to your waterfront mansion in the Hamptons where you can play tennis and hobnob with your fellow socialites. The matter of repairing the mess you have created should be left to professional management and those that have an economic stake in the outcome."

THREE WEEKS LATER, Irik Sevin resigned from Star Gas Partners. Within a year the company was recapitalized by Kestrel Energy, a private equity firm affiliated with Yorktown Partners. Kestrel had previously owned Meenan Oil, which was the country's third-largest heating oil distributor when Star Gas bought it in 2001. Star Gas would remain publicly traded after the Kestrel recap, and Meenan's management team, which had never left, would run the whole company. Both the board of directors and the management team had large equity stakes in the business. Management's first move was to return to a localized customer service model.

Star Gas thrived in the years after Dan Loeb demanded the resignation of its chairman and CEO. Despite arguably tougher industry conditions, with wildly volatile heating oil prices that reached $4 per gallon,

and a painful economic recession, the company has almost doubled its per-gallon gross profits. Since Kestrel took control in 2006, Star Gas has paid $115 million in dividends and made $249 million worth of acquisitions. It has done this without increasing long-term debt or issuing a single share to raise capital. In fact, the company has spent $83 million retiring 24% of its shares on the open market. The company's pretax, pre-interest earnings over the past year were better than Sevin's Star Gas managed in its best year as a combined propane and heating oil company.[32] And, of course, Star Gas's CEO's salary is 40% lower than Irik Sevin's was.[33]

Redefining Businesslike Behavior

At the very end of *The Intelligent Investor*, Benjamin Graham writes, "Investment is most intelligent when it is most *businesslike*." People often refer to this sentence to explain Graham's idea that investors should view shares in a company as fractional ownership interests. But Graham meant so much more than that—the statement is really a philosophy of investing. He is saying that *because* buying shares is the same as buying a fractional interest in a company, an investor should treat the endeavor "as a business venture of his own." Generating superior returns thus requires a prudent businessman's approach to every element of his or her investment process.

Of course, when Benjamin Graham discusses "accepted business principles," he might exclude public letters calling out a CEO's seventy-eight-year-old mother, and referring to soiled underwear or skin flutes. But today's accepted business practices, for better or for worse, tolerate a level of fanaticism that Graham might view as alien. William Thorndike's book *Outsiders* profiles CEOs who excelled through wise capital allocation. But there could be a second volume called *Maniacs*, with chapters on obsessive characters like Steve Jobs, Ray Kroc, Ross Perot, Tom Monaghan, Les Schwab, and Herb Kelleher. In the ranks of these lunatics, we would find many of the characters in this book, from Louis Wolfson to Carl Icahn to some of today's activist hedge fund managers who have taken intelligent investing to extremes.

My favorite book about the hedge fund business is David Einhorn's *Fooling Some of the People All of the Time*. It is a remarkable document—a very detailed account of Einhorn's short position in a small business development company called Allied Capital from 2002 through 2007. It captures the very first conversation Einhorn and his coworkers at Greenlight Capital had with Allied—Greenlight records its research calls—and then walks readers through five and a half years of the fund's quixotic effort to expose Allied's aggressive accounting practices to regulators, analysts, journalists, and other investors.

David Einhorn is one of today's most successful hedge fund managers—Greenlight Capital reportedly manages $10 billion—so his time is incredibly valuable. Being a professional investor, he must also have a keen sense of return on capital. Yet he and his coworkers logged countless hours and days pursuing Allied, which, especially by the end of the saga, could not have been a very big position in the fund. There's a telling moment in the book, when Einhorn visits with Warren Buffett in the first installment of Buffett's annual eBay charity lunch. With his private time with the world's greatest investor, Einhorn can't help himself. He has to pick Buffett's brain about Allied Capital.

David Einhorn's short position in Allied Capital became a holy mission. He wasn't doing it for personal gain: The year he put the position on he pledged half his profits to charity (he ultimately donated them all). And there really is no glory in short selling, even when the target is a scuzzy BDC like Allied. Yet Einhorn not only sunk an ungodly amount of time into the idea, he wrote a four-hundred-page antemortem book about it. The whole thing is a bit mind-boggling.

Whether it was Daniel Loeb attacking Irik Sevin's mother or David Einhorn writing the great American novel about a 3% position in his fund, there was something peculiar about hedge fund managers paying attention to targets in a way that didn't seem to make economic sense. Sevin was by no means the most dangerous and incompetent executive in America. He didn't manage Star Gas's heating oil business very well, but if oil hadn't doubled in price he might still be the company's CEO. As for Allied Capital, it certainly overvalued the assets on its balance sheet, but so did many other companies in the same industry (and some

in much larger industries with more damaging effects to U.S. economy). There is a certain capriciousness to Sevin and Allied becoming top hedge fund targets, and Dan Loeb knew this when he invoked the "public hanging" metaphor. He was warning other public company management teams, "We're watching you, and you might be next." Later hedge fund targets would be much larger and more established companies. Einhorn accused Lehman of aggressive accounting, Loeb exposed the Yahoo! CEO for padding his resume, and Bill Ackman's Pershing Square Capital took on the multilevel-marketing great white whale, Herbalife, in a fight-to-the-death cage match.

WHEREAS CORPORATE RAIDERS busted through gates with hostile tender offers for control and a supporting army of arbitragers, early hedge fund activism was an exercise in persuasion. The ultimate arbiters in many of these disputes were large institutional investors like CalPERS and CalSTERS. It didn't take long for them to start siding with activist hedge funds' campaigns against underperforming management teams. Ridicule as a radiating weapon became unnecessary, and even counterproductive, as hedge fund shareholder activism matured to focus on board representation and proxy fights.

For large institutional investors, their symbiotic relationship with hedge fund activists makes it easier for them to pressure companies behind the scenes. Sometimes they'll even seek out activists for investments they think will benefit from intervention. And, perhaps most important, as activism has become rampant, institutional investors have gotten much better at evaluating campaigns led by hedge funds, and casting their votes wisely. If an activist campaign is based on really stupid ideas, it probably won't gain much support. Thirty years ago, a company under attack from shareholders almost invariably ended up in play. The endgame, where the company was sold even if the timing was bad, was almost inevitable. To quote the great R. Kelly, "it was like Murder She Wrote."[34] As CalPERS's director of global governance, Anne Simpson, told the *New York Times* in late 2013, "shareholder activism is evolving from barbarians at the gate to acting as owners."[35]

This so-called evolution—wherein hedge fund activists are no longer

outsiders but, instead, welcomed with open arms by large institutional investors—has had a profound effect on corporate America. *No company is off-limits unless it has locked up its voting control.* Hedge fund activists have waged campaigns in recent years against Apple and Microsoft, the two largest public companies in the world. Carl Icahn pressured Apple to return more capital to shareholders. Even though he didn't rally much support from other investors, it certainly looks like his actions influenced the company to increase its buyback. ValueAct owned less than 1% of Microsoft but managed to place a representative on the company's board of directors. It's hard to imagine hedge funds pulling off a similar feat a decade ago.

Of course, there is one obvious and fundamental flaw with the idea that hedge fund activists will ever be fully aligned with long-term owners. Hedge funds are not structured to run long-term money. Running proxy fights and serving on corporate boards can tie up capital and create a mismatch between the duration of an activist investment and the liquidity terms of the fund. Many hedge funds will tell you that their investors are committed and long term, but that won't be true if their performance starts flagging. As much as hedge funds talk about being long-term owners, it is ultimately an aspirational sentiment.

To successfully run a long-term investment strategy with a hedge fund, you can't just ignore your own short-term business pressures. You must consider catalysts and exit strategies. This is why public company defenders like Marty Lipton are quick to point out that populist statements from hedge fund managers about being long-term owners are more self-serving than accurate. Dan Loeb's investment in Star Gas is instructive here. I wrote earlier about the great success the company has had since its ownership overhaul in 2006. But Loeb actually did not stick around for the turnaround. With Sevin out and the recapitalization completed, the "event" and "catalysts" had come and gone. Investors were tired of Star Gas, and large blocks of shares sat in the hands of participants in the recap. Star Gas was destined to be dead money for a while, and Loeb had better uses for his capital. As he told *New York* magazine's Steve Fishman in 2004, "The only thing I care about is making money for my investors."[36] Mr. Pink does not lie.

The good news for today's investors is that when hedge fund managers like Dan Loeb try to make money in the market, it's usually in their best interest to benefit other shareholders as well. It's much harder for activists to generate good returns for themselves while screwing everyone else, as we saw in the days of greenmail. The awakening of large institutional investors has a lot to do with this dynamic. When passive investors vote shares wisely, it channels shareholder activism in a positive rather than destructive way. For ValueAct to get a great return by owning less than 1% of Microsoft, for example, all Microsoft shareholders need to benefit.

But just as with the Proxyteers and the corporate raiders, we shouldn't get suckered into believing everyone that spouts pro-shareholder populism. A good window into activists' real intentions with regard to other shareholders comes when they get control of a company. Like the proxyteers and raiders before them, the hedge funds have a spotty record. Perhaps the best example of this is the Sardar Biglari saga at Steak 'n Shake.

An Ethos of Caring

Sardar Biglari is the chairman and CEO of Biglari Holdings, which owns Steak 'n Shake, as well as an insurance company and the magazine *Maxim*. His background is fascinating. The son of a former Iranian military officer who was imprisoned after the 1979 revolution, Sardar lived part of his childhood under house arrest with his mother.[37] He was seven years old when he moved with his family to the United States in 1984. The only words he knew in English were *hi* and *bye*.[38]

When Biglari was nineteen, he read *The Warren Buffett Way* and became interested in investing. He started his own hedge fund after graduating from college, and made a large investment in a restaurant company called Western Sizzlin. After joining the company's board, Biglari helped reorganize the business with a franchising focus and allocated its excess capital into a highly successful activist investment in Friendly's Ice Cream. Biglari's next target was Steak 'n Shake, the iconic midwestern burger chain that inspired Danny Meyer's Shake Shack. Steak 'n Shake had squandered huge amounts of money opening new

restaurants while letting performance deteriorate in its existing store base. Biglari was elected to the board of directors in March 2008 and became CEO in early August. Steak 'n Shake was on the verge of default and the country was about to experience a harrowing financial crisis and recession.

Barely thirty years old and with no experience operating restaurants, Biglari pulled off a remarkable turnaround at Steak 'n Shake. After negotiating some wiggle room from his lenders, he aggressively cut costs and simplified the menu. Then, in a gutsy move given the company's precarious financial state, he drastically reduced prices for his customers. Steak 'n Shake saw huge increases in guest traffic and profitability against the backdrop of a struggling economy.

Sardar Biglari created a lot of wealth for Steak 'n Shake's shareholders by saving the company and restoring it to a profitable growth trajectory. But since doing so, he's made a series of controversial moves to entrench himself at the company and maximize his compensation. As one hedge fund manager said to me, "He talks like Warren Buffett but then acts like Ron Perelman!"

Biglari once wrote to Western Sizzlin shareholders, "We intend for the entire organization to exhibit an ethos of caring about its shareholders. . . ."[39] He has since consolidated Steak 'n Shake and Western Sizzlin into a company called Biglari Holdings, which, according to recent SEC filings, has invested $620 million into Sardar's hedge funds. While Biglari's direct ownership in his namesake is less than 2% per his most recent SEC ownership filing, he controls almost 20% through his hedge funds.[40] He stands to earn a 25% incentive fee after a 6% hurdle rate for investing Biglari Holdings' capital.

The hedge fund investments also serve as a powerful entrenchment device, because Biglari Holdings' capital is subject to rolling five-year lockups at Sardar's funds. To further protect his position, Biglari agreed to license his name to the company at a cost of 2.5% of revenues per year should he ever be removed as chairman or CEO, or should he be stripped of capital allocation duties. So if angry investors ever conspire to push out Sardar Biglari, the company will be stuck for

years paying him so it can use the phrase "Steak 'n Shake by Biglari" (assuming the agreement holds up in court). Two and a half percent of the company's most recently reported annual revenues comes out to almost $20 million, 70% of the company's 2014 earnings.

Biglari's compensation (excluding any money he makes from the hedge fund arrangement) is also aggressive. Biglari Holdings' last proxy statement showed that he made more than $10 million in each of the previous two years. That's more compensation than the CEOs of much larger companies, including McDonald's, Burger King, Popeyes, and Wendy's. Biglari's payout formula is based on increases in the company's book value. In 2014, Biglari Holdings made a rights offering to shareholders at a 40% discount to the share price.[41] This forced shareholders to pony up more money to prevent their ownership from being diluted. The net effect of the rights offering? Biglari Holdings received an infusion of capital that increased the company's book value, making Sardar's compensation go up. If the proceeds are then invested in his hedge funds, he'll also get 25% of the profits after the 6% hurdle rate.

Because of Sardar Biglari's success creating value for Steak 'n Shake shareholders, investors have mostly tolerated his entrenchment tactics and rich compensation. After a few small shareholders launched a proxy fight for control of Biglari's board, famed value investor and shareholder advocate Mario Gabelli told a reporter for the *Indianapolis Star* that he was likely to support the incumbents.[42] Biglari, for his part, appears to be considering a variant of the "Pac Man" defense. Through his hedge fund, he's bought large stakes in two companies where his dissident shareholder serves on the board.

Sardar Biglari's maneuvers will undoubtedly test institutional investors' patience. If he continues to make money for shareholders through smart investments and good restaurant operations, I suspect he will hold on to his position at Biglari Holdings and prosper. But investors will be wary of his moves on other companies. Despite owning 20% of the stock and exhibiting valuable restaurant operating chops, Biglari has failed to win board representation at Cracker Barrel several years running. He showered shareholders with elegantly written letters skewering the

company's operating performance, but they didn't resonate with Cracker Barrel's institutional shareholder base. The poison pen will only get you so far if shareholders don't trust you. In 2007, Biglari wrote a letter to shareholders of Friendly's Ice Cream that stressed "public shareholders' interests should come first." He wrote, "The private jet symbolizes an ongoing culture, one that doesn't care about its shareholders."[43] Restaurant finance writer Jonathan Maze reported in 2014 that Biglari Holdings has registered ownership interests in four jets.[44]

Few hedge fund managers have been as aggressive as Sardar Biglari. When David Einhorn took effective control of Einstein Noah Restaurant Group, he did not rename it Einhorn Restaurant Group and buy four private jets. But Biglari's story, which takes hedge fund shareholder activism to a post-ideological extreme, is instructive. As we have seen, much of the power in our corporate governance system now lies with shareholders. Activist hedge funds were once the pipsqueaks—renegades like Dan Loeb and Bob Chapman who tossed stink bombs into corporate boardrooms—but today they have teamed up with large institutional investors and can win access to almost any boardroom in America. This makes it harder to blame the traditional corporate governance whipping boys (such as captive boards and the separation of management and ownership) when companies stumble. Shareholders must share the blame when governance goes bad. As much as they champion shareholder value and sound corporate oversight, even the most sophisticated investors have a habit of conveniently ignoring warning signs when they are making good money. Unless Sardar Biglari's stock tanks, the market will be permissive of his self-dealings. If he falters, the shareholders will be ruthless.

Investing in public companies is a dangerous pursuit that requires risking real money based on limited information. Even when you are diligent about buying at a margin of safety, you will still make money-losing mistakes. Aspiring investors who require perfection have gotten into the wrong business. Dan Loeb had his Massey Energy, Einhorn his New Century, Klarman his HP, Ackman his JCPenney, and Icahn his Blockbuster Video—all of which suffered steep losses.

Even Warren Buffett had his Berkshire Hathaway, and those pesky Irish banks. When activism goes bad, the glee among rubbernecking investors is palpable. But rather than just point our fingers and gawk, let's dive into some wreckage caused by failed activism and see what we can learn. And don't worry, we can gawk some, too.

managers based in corporate headquarters and a vast group of shareholders spread all over the world."

53. See Jonathan Macy, *Corporate Governance: Promises Kept, Promises Broken* (Princeton, NJ: Princeton University Press, 2011), 51: "Perhaps the most basic principle of corporate law in the United States is that corporations are controlled by boards of directors, rather than shareholders. . . . Specifically, under U.S. law, corporations are managed by or under the direction of boards of directors, making the directors literally the governors of the corporation."
54. This is Karla's memory of what Peter said about a friend who was ultimately appointed to the R. P. Scherer board.
55. Arthur Levitt, *Take on the Street* (New York: Pantheon Books, 2002), 201.
56. Monks and Minow, *Corporate Governance*, 257.
57. Macey, *Corporate Governance*, 64.
58. James Madison, Federalist 10, again per Macey, *Corporate Governance*.
59. Warren E. Buffett, "2002 Chairman's Letter," Berkshire Hathaway, February 21, 2003.
60. Jim Jelter, "Coca Cola Executive Pay Plan Stirs David Winters' Wrath," *WSJ Marketwatch*, March 24, 2014.
61. Form 8-K, Securities & Exchange Commission, April 23, 2014.
62. Carl C. Icahn, "Why Buffett Is Wrong on Coke," *Barron's*, May 3, 2014.
63. Warren E. Buffett, 2014 Berkshire Hathaway shareholders meeting, May 3, 2014.
64. George W. Bush, "Remarks on Signing the Sarbanes-Oxley Act of 2002," July 30, 2002, *Public Papers of the Presidents of the United States: George W. Bush, Book II: Presidential Documents—July 1 to December 31, 2002* (Washington, DC: U.S. Government Printing Office, 2002), 1319–21.
65. Macey, *Corporate Governance*, 81.
66. Alex Erdeljan, interview with the author, July 21, 2014.
67. All of these figures come from R. P. Scherer annual reports between 1984 and 1999.
68. Erdeljan interview.

7: Daniel Loeb and Hedge Fund Activism: The Shame Game

1. Or, as his lawyers succinctly put it, the filing "shall not be construed to be an admission by the Reporting Persons that a material change has occurred in the facts set forth in this Schedule 13D or that such amendment is required under Rule 13d-2 of the Securities Exchange Act of 1934, as amended." Ron Burkle, "The Yucaipa Companies," 13d Morgans Hotels, amendment 10, September 3, 2013.
2. Ibid.
3. Robert A. G. Monks and Nell Minow, *Corporate Governance*, 5th ed. (Hoboken, NJ: Wiley, 2011), 220.
4. Jack D. Schwager, *Market Wizards: Interviews with Top Traders* (New York: HarperBusiness, 1989), 117.
5. Warren Buffett, "Our Performance in 1963," letter to partners, January 18, 1964: "Our willingness and financial ability to assume a controlling position gives us two-way stretch on many purchases in our group of generals." Warren Buffett, "Our Performance in 1964," letter to partners, January 18, 1965: "Many times in this

category we have the desirable 'two strings to our bow' situation where we should either achieve appreciation of market prices from external factors or from the acquisition of a controlling position in a business at a bargain price. While the former happens in the overwhelming majority of cases, the latter represents an insurance policy most investment operations don't have."

6. Letter from Robert L. Chapman to Mr. Lawrence W. Leighton, Securities and Exchange Commission Schedule 13D, May 18, 1999.
7. Letter from Robert L. Chapman to Riscorp/Mr. Walter L. Revell, Securities and Exchange Commission Schedule 13D, October 28, 1999.
8. Letter from Robert L. Chapman to ACPT/J. Michael Wilson, Securities and Exchange Commission Schedule 13D, March 30, 2000. Chapman uses such crazy words, I don't know if "underserved" is a typo or not.
9. Deepak Gopinath, "Hedge Fund Rabble-Rouser," *Bloomberg Markets*, October 2005.
10. "Around the World with Robert Chapman," interview by Emma Trincal, January 5, 2006, http://www.thestreet.com/print/story/10260146.html.
11. Gopinath, "Rabble-Rouser."
12. The "buyside" refers to the investment management business while the "sellside" refers to the broker-dealer business.
13. Gopinath, "Rabble-Rouser."
14. Jefferies pleaded guilty to two felony charges in 1987 and resigned from his company.
15. "DBL Liquidating Trust Payouts to Creditors Exceed Expectations . . . Trust Aims to Complete Activities in One Year," Business Wire, April 26, 1995, http://www.thefreelibrary.com/DBL+LIQUIDATING+TRUST+PAYOUTS+TO+CREDITORS+EXCEED+EXPECTATIONS+. . . . . .-a016863686.
16. "Liquidation of Drexel Is Ending on a High Note," *Los Angeles Times*, March 28, 1996.
17. Katherine Burton, *Hedge Hunters: After the Credit Crisis, How Hedge Fund Masters Survived* (New York: Bloomberg Press, 2010), 195.
18. Robert E. Wright and Richard Scylla, "Corporate Governance and Stockholder/Stakeholder Activism in the United States, 1790–1860: New Data and Perspectives," in *Origins of Shareholder Advocacy*, edited by Jonathan G. S. Koppell (New York: Palgrave Macmillan, 2010), 244.
19. Connie Bruck, *The Predators' Ball: The Inside Story of Drexel Burnham and the Rise of the Junk Bond Raiders* (New York: Penguin, 1989), 315.
20. Gopinath, "Rabble-Rouser."
21. William Thorndike, *The Outsiders: Eight Unconventional CEOs and Their Radically Rational Blueprint for Success* (Boston: Harvard Business Review Press, 2012), has an entire chapter on Stiritz.
22. Dan Loeb letter to William Stiritz, Agribrands, September 8, 2000.
23. Agribrands definitive proxy statement March 19, 2001.
24. Daniel Loeb letter to James Dearlove chairman and CEO of Penn Virginia, December 11, 2002.
25. Letter from Daniel Loeb to John W. Collins, chairman and CEO of InterCept, Securities and Exchange Commission Schedule 13D, May 27, 2004.
26. Letter from Daniel Loeb to John W. Collins, chairman and CEO of InterCept, Securities and Exchange Commission Schedule 13D, June 24, 2004.

27. Gopinath, "Rabble-Rouser."
28. Star Gas is a publicly traded master limited partnership, so "shares" are really "units," but I'm going to stick to "shares" and "stock" for simplicity's sake.
29. Star Gas Partners, third-quarter 2004 earnings conference call, July 29, 2004.
30. Star Gas Partners third-quarter 2003 earnings conference call, August 6, 2003.
31. All these figures are from Star Gas Partners SEC filings.
32. I'm using EBITDA minus capital expenditures, as Star Gas amortizes its acquired customer lists. Sevin's best year was $93 million of EBITDA minus capex. In 2014, SGU did $99 million of EBITDA minus capex.
33. Full disclosure, I own SGU shares, as does the fund I manage.
34. R. Kelly, "Ignition (Remix)."
35. Randall Smith, "Some Big Public Pension Funds Are Behaving Like Activist Investors," *New York Times*, DealBook, November 28, 2013.
36. Steve Fishman, "Get Richest Quickest," *New York*, November 22, 2004.
37. Max Olson, "The Restaurant Investor," Max Capital Corporation/Futureblind.com, November 25, 2009.
38. Greg Wright, "Friendly Ice Cream Cool to Overtures from Dissident Biglari," Dow Jones Newswires, March 8, 2007
39. Olson, "The Restaurant Investor."
40. Biglari Holdings Form 4 filing, January 15, 2015.
41. The rights price was $250 per share and the closing price on the day of the announcement was $432.
42. Jeff Swiatek, "Steak 'n Shake-up Looming? Investor Launches Effort to Oust Parent Firm's CEO Biglari," *Indianapolis Star*, January 18, 2015.
43. Letter from Sardar Biglari to Friendly's Shareholders, Securities and Exchange Commission Schedule 13D, March 6, 2007.
44. Jonathan Maze, "Biglari Holdings Co-Owns a Few Jets," *Restaurant Finance Monitor*, September 17, 2014. http://registry.faa.gov/aircraftinquiry/Name_Results.aspx?Nametxt=BIGLARI&sort_option=1&PageNo=1

8: BKF CAPITAL: THE CORROSION OF CONFORMITY

1. Katrina Brooker, "How Do You Like Bill Ackman Now?" *Bloomberg Markets*, February 2015.
2. Pershing Square Capital Management LP, Securities and Exchange Commission Schedule 13F, November 14, 2014. The 13F excludes foreign position, unlisted companies, debt securities, and short positions.
3. These figures are from the presentation "Think Big," Pershing Square Capital Management LP, May 16, 2012.
4. I could swear I heard Ackman make this analogy himself, but I can't remember when or where.
5. Svea Herbst-Bayliss and Katya Wachtel, "Hedge Fund Manager Ackman Says Mistakes Made in JC Penney Turnaround," Reuters, April 5, 2013.
6. Brooker, "Bill Ackman."
7. For an example see Lucian A. Bebchuk, Alon Brav, and Wei Jiang, "The Long-Term Effects of Hedge Fund Activism," which tackles both operating performance and