Activist hedge funds and the erosion of Rhenish capitalism:
The impact of impatient capital

by

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Abstract

‘Patient capital’ is generally seen as fundamental to non-market coordination, typically found in coordinated market economies. It shields firms from hostile takeovers, hence relieving them from overly concern with short-term market objectives. An ownership structure that is dominated by blockholdings can be seen as central for this institutional configuration, which has been traditional to ‘Rhenish’ capitalism. Empirical study of the 160 largest listed corporations shows that by 2008 *de jure* blockholdings have declined notably in Germany and foreign investors have strongly increased their holding of shares in general and of *de facto* blockholdings in particular. This development has enabled activist hedge funds – largely unregulated institutional investors of Anglo-American origin – to have an impact on Rhenish capitalism. Research of ten cases of hedge fund activism in Germany shows that this ‘*impatient* capital’ has gained ‘disciplinary power’ over publicly listed corporations that are not protected by Rhenish blockholders, thus provoking institutional change.

Keywords: capitalism, varieties of; corporate governance; financial markets; Germany; institutional change

JEL classification: G3 Corporate Finance and Governance, P5 Comparative Economic Systems

1. Introduction

'Patient capital' (Hall and Soskice, 2001) is generally seen as fundamental to non-market types of economic coordination (Amable, 2003; Culpepper, 2005; Yamamura and Streeck, 2003). This institution[1] represents a central feature of coordinated market economies (CMEs), because it shields firms from hostile takeovers, 'thus freeing them from obsessive concern with short-term market indicators' (Culpepper, 2005, p. 175). Germany – also referred to as 'Rhenish' capitalism (Albert, 1993) – is often portrayed as a prototypical example of CMEs. Rhenish capitalism is identified as a socio-economic system in which firms mostly pursue long-term economic objectives and rely not exclusively on competitive market mechanisms but also heavily on cooperative forms of non-market strategic interaction and coordination (Hall and Soskice, 2001). 'The underlying logic, informing all parts of the German political economy, has been shaped by a network type of control. This has aimed for stability and growth, rather than for short-term high returns on investment.' (Lane, 2003, p. 86). Financial markets traditionally did not play a pivotal role, either as sources for external finance or in terms of corporate control. This is in contrast to the liberal market economy (LME) of Anglo-American pedigree, in which financial markets – including actors such as activist hedge funds – play a paramount role for both company finance and corporate control. Competitive arms-length market mechanisms dominate this variety of capitalism and firm behavior is much more oriented towards individual success and short-term financial profits – epitomized by the shareholder value paradigm. Hence, Anglo-American corporate governance in general prioritizes the interests of the shareholders (outsider control), whereas Rhenish capitalism traditionally has been a stakeholder oriented model of corporate governance (insider control). Since the early 1990s there has been an ongoing discussion about the convergence of CMEs towards the LME model. In the case of Germany this debate has often been about the 'erosion of Rhenish capitalism' through institutional change provoked by private transnational[2] actors. These actors (mostly of Anglo-American origin) are generally comprised of large multinational corporations, rating-agencies, accounting standards boards or law firms (Jackson and Höpner, 2001 and 2006; Nölke and Perry 2007; Wigger and Nölke 2007; Nölke

1 Institutions are understood here broadly as 'building-blocks of social order, ... socially sanctioned, that is, collectively enforced expectations with respect to the behavior of specific categories of actors or to the performance of certain activities. Typically they involve mutually related rights and obligations for actors, distinguishing between appropriate and inappropriate, 'right' and 'wrong', 'possible' and 'impossible' actions and thereby organizing behavior into predictable and reliable patterns.' (Streeck and Thelen, 2005, p. 9).

2 Transnationalization is one of four categories of institutional change identified by Deeg and Jackson (2007)

2008). Another observer has called this ongoing process 'the Americanization of European Finance' (Sablowski, 2009).

This article is a contribution to this ongoing debate. In particular, it argues that a general decline of blockholdings since the early 1990s has created new opportunities for foreign investors to have an impact on corporate governance in Germany. Foreign investors, including activist hedge funds from the US and the UK, have greatly increased their holdings in German publicly listed companies during the last decade. For activist hedge funds, in contrast to typical Rhenish blockholders, the maximization of shareholder value in the short-term is paramount. According to Kahan and Rock (2007, p. 1068), 'hedge funds come close to being the archetypical short-term investor.' In this vein they are one of the most paradigmatic classes of actors representing the LME model. By putting pressure on German corporations to focus on short-term profit maximization this 'impatient capital' can function as a transnational agent of institutional change towards a system of outsider control in Germany. This is extremely relevant as 'the continued viability of this institutional diversity [of capitalism] hinges on the ability of coordinated financial systems, such as those in Germany and Japan, to shield company managers from the short-term imperatives characteristic of LMEs' (Culpepper, 2005, p. 173). The aim of this article is to analyze the consequences of hedge fund activism for the German political economy. Hence, the empirical focus of this article is ten publicly listed German companies in which activist hedge funds have invested between the end of 2000 and the beginning of 2009.

This paper is organized in five sections. The second section of this article analyzes continuity and change in the German system of corporate governance since the 1990s. The empirical focus of this part is the ownership structure of stockmarket-listed corporations in Germany during the last two decades – especially the general decline of blockholdings and the rise of foreign investors. This changed pattern of ownership is of central importance because it has major consequences for the scope of influence that activist investors, such as hedge funds, are able to exert. The third section presents some necessary facts about the international hedge fund industry and shows that hedge funds are clearly actors of Anglo-American origin – both in terms of their legal domiciles and the locations of their managers. The penultimate section presents findings about ten empirical cases of hedge fund activism in Germany. This part

that challenges the (traditional) comparative capitalisms literature.

discusses whether activist hedge funds have exerted 'disciplinary power' over German companies and whether these funds have contributed to a 'joint belief shift' of economic actors in the German political economy. The final section presents conclusions about the impact of activist hedge funds on Rhenish capitalism.

2. German corporate governance: continuity and change since the 1990s

'Forms of corporate governance ... decisively shape the logic of the whole political economy' (Lane, 2003). However, there are different definitions of the term. A quite narrow definition stems from Shleifer and Vishny (1997, p. 737): 'Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.' A definition that is wider and more appropriate to the theme of this article is given by Dore (2005, p. 437): Corporate governance is 'the set of institutions … which determine the distribution, among the various people (stakeholders) who have dealings with or work in a corporation, of the power (a) to determine what the corporation or its agents do, and (b) who profits from the value added by its activities. 'Power' here means effective power, i.e. not just legally or organizationally prescribed power.' Hence, according to this definition, the individual or group who wields the de facto power over the corporation is the most important aspect of corporate governance.

The German economy has often been characterized as the stereotypical example of a corporate governance system characterized by insider controlled, stakeholder oriented, and in which banks play a central role (Hackethal *et al.*, 2005). For over a century large private banks have been at the heart of a dense web of controlling block- and crossholdings that was part and parcel of the 'Deutschland AG' (Beyer, 2002; Höpner and Krempel, 2004). Together with the mandatory co-determination of labor and other German blockholders such as private investors (often the founding families of corporations) and non-financial firms, banks formed the 'governing coalition' (Hackethal *et al.*, 2005) of the German variety of capitalism. Traditionally, this governing coalition has wielded de facto power over corporate control in Germany. Long-term growth and stability of the company have represented their primary objectives. This was consistent with the coordinated market economy model that distinguished Rhenish capitalism. Combined with the virtual absence of hostile takeovers, this institutional configuration of insider-controlled German corporate governance has traditionally allowed management to promote long-term company growth instead of short-

term profitability (Höpner, 2005). In the words of Culpepper (2005, p. 175), 'blockholders can protect company managers from the possibility of a hostile takeover, thus freeing them from obsessive concern with short-term market indicators.'

2.1. Traditional blockholding in Germany

The ownership structure has been of central importance to the long-term focus of many German firms. Banks and controlling blockholders (patient capital) not only had financial interests in the firm, but more importantly, they had strategic interests in the company that were necessarily long-term in nature. This configuration has generally led to comparatively low-risk investments and longer-term strategies on the part of the corporation. On the other hand this stable ownership pattern can be seen as detrimental to the development of highly liquid capital markets and especially impedimental for the formation of active public markets for corporate control (Roe, 2003). However, Jenkinson and Ljungqvist (2001) have argued that a market for corporate control does exist in Germany, but that it takes the form of a market for blocks of shareholdings. In addition, Jackson and Miyajima (2007) have stressed that there are 'varieties' of markets for mergers and acquisitions (M&A), e.g. in CMEs these markets are generally less hostile. 'M&A has developed along a path dependent trajectory characterized by more 'coordinated' types of transactions in Japan, France and Germany as opposed to the more 'arm's length' deals in the US and UK' (Ibid., p. 24).

The connection between the interests of the governing coalition made up by blockholders, banks and labor, and the ownership structure are reflected in statistics from the early 1990s. According to Franks and Mayer (2001) 85.4% of 171 large quoted industrial and commercial companies in Germany had a blockholder owning more than 25% of company shares in 1990. Non-financial corporations accounted for 27.5% of these blockholdings followed by private investors (family groups) with 20.5%. Trusts held 12.9% while foreign companies accounted for 9.9% of shareholdings larger than one quarter of company shares. Perhaps surprisingly, banks accounted for only 5.8% of blockholdings, but they were much more prominent at the top of complex pyramid structures involving several tiers of control. Last, the German state and other authorities accounted for 4.7% of blockholdings, trailed only by insurance companies with 1.8%.[3] This traditional ownership structure of publicly listed companies in Germany, effectively controlled by insiders, left little to no room for shareholder activism by

outsiders such as pension funds, activist hedge funds or other institutional investors.

This configuration of the German system of corporate governance began to undergo profound changes in the 1990s when the internationalization and globalization of financial markets increased cross-border competition between financial institutions. Hence, the large private banks and the leading insurance corporations began to sell their various blockholdings and disentangled their web of pervasive cross holdings in order to expand or diversify into new markets.[4] This process of the 'unbundling of corporate Germany' was particularly catalyzed by the Tax Reduction Act ('Steuersenkungsgesetz') of 2000 that exempted capital gains by the sale of blockholdings from tax starting in 2002 (Nowak, 2004).

2.2. De jure blockholdings in Germany at the end of 2008

Research by the author involving the 160 largest quoted German corporations that constitute the DAX, MDAX, SDAX and TecDAX share indices of the Deutsche Börse has shown that by the end of 2008 the proportion of companies with a single shareholder in excess of 25% has dropped to 56.25% (Table 1). This figure is still much higher than in the US or the UK where blockholding generally is less frequent. Nonetheless, compared to the 171 German companies studied by Franks and Mayer in 1990 (85.4%) the share of the largest listed German corporations that have a blockholder has declined notably by nearly 30 percentage points. The only group that has actually increased its blockholdings (by over one third to 28.75%) is private investors (including family groups). From 1990 to 2008 blockholdings by non-financial corporations have fallen by about two thirds to 9.38%, banks have decreased by more than half to 2.5% and insurance corporations have fallen by two thirds to a minuscule 0.62%. The German government (including the local, regional and national levels) has remained more or less constant with 5% as well as foreign investors with 10%.[5]

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3 See Faccio and Lang (2002) for the ultimate ownership structures of corporations in Western Europe.

4 On the dense network of cross holdings in Germany during the 1990s and its legal underpinnings confer Adams 1999); on the dissolving of this web of cross holdings from 1997-2001 see (Wójcik 2003).

5 Note that the group 'trusts' used by Franks and Mayer (2001) is not applicable to the 160 German companies studied by the author at the end of 2008.

Table 1 De jure blockholdings in the 160 largest listed German firms at the end of 2008

	No block-holder	Private investor	Non-financial	Govern-ment	Bank	Insurance company	Foreign investor
DAX	16	5	5	4	0	0	0
MDAX	22	10	4	3	1	1	9
SDAX	15	22	5	1	2	0	5
TecDAX	17	9	1	0	1	0	2
Total:	70 (43.75%)	46 (28.75%)	15 (9.38%)	8 (5.0%)	4 (2.5%)	1 (0.62%)	16 (10.0%)

Sources: Hoppenstedt database on German firms; company websites.

A stake in the voting stock of a company between 25% plus one share and 30% minus one share is a relevant parameter, because it constitutes a *de jure* blockholding in the annual general meeting (AGM) of a German publicly listed company.[6] This blocking minority enables the holder to prevent the merger with another firm or the issue of new shares; the discharge from liability to the members of the management and supervisory boards can also be prevented with such a stake.[7]

2.3. De facto blockholdings in Germany at the end of 2008

During the past decade, the average presence of voting stock at AGMs of German companies hovered around only 50% (Licharz 2008). It therefore makes sense to argue that there is also a *de facto* blockholding which then would range from about half the 25% plus one share of a *de jure* blockholding – that is between 12% and 13% – to 25%.[8] Table 2 shows the level of blockholding in Germany according to this threshold at the end of 2008. Total blockholdings in the 160 largest German publicly listed companies analyzed from this vantage point increase from 56.25% to 69.37%. However, the significant finding here is that the *de facto* blockholdings by foreign investors are by 75% larger than their *de jure* blockholdings (an increase by 7.5 percentage points).[9] The other groups either have increased by a high factor but still remain marginal (banks and insurance corporations) or, remain practically constant

6 According to the German Takeover Act of 2002 a shareholder has to make a public offer for the outstanding shares of the company upon reaching the threshold of 30% of voting stock.

7 Many US studies define blockholding as a stake of more than five percent of voting stock. This stems from the fact that in this case funds have to file a regulatory disclosure with the SEC (Clifford 2008). However, the focus of this paper is *control* and therefore blockholding has been defined in the manner stated above.

8 This *de facto* blockholding is of course only valid for companies with an otherwise dispersed share ownership; the presence of a *de jure* blockholding renders a single *de facto* blockholding of 12% to 13% virtually irrelevant in terms of corporate control.

9 Interestingly, foreign investors seem to prefer small and medium German listed firms of the TecDAX, SDAX

(non-financial corporations and government). Though the group of private investors increases its share by an absolute 3.75 percentage points (from 28.75% to 32.5%), the relative increase is only about 13%. Hence, foreign investors are much more frequently acquiring *de facto* blockholding stakes that range from about 12-13% to 25% than German investors. These data show that when Germany-based investors strive for corporate control they generally seek full *de jure* control, whereas *de facto* control seems to be sufficient for foreign investors.

Table 2 De facto blockholdings in the 160 largest listed German firms at the end of 2008

	No block-holder	Private investor	Non-financial	Govern-ment	Bank	Insurance company	Foreign investor
DAX	14	5	5	4	0	0	2
MDAX	16	12	5	3	2	2	10
SDAX	9	23	5	1	2	0	10
TecDAX	10	12	1	0	1	0	6
Total:	49 (30.63%)	52 (32.5%)	16 (10.0%)	8 (5.0%)	5 (3.12%)	2 (1.25%)	28 (17.5%)

Sources: Hoppenstedt database on German firms; company websites.

2.4. Development of the general ownership structure

De jure and *de facto* blockholdings are of central importance because they determine who exerts effective control – one of the most pivotal aspects of corporate governance – over publicly listed companies in Germany. It is furthermore important for the subject of this article to investigate the general ownership structure of publicly traded corporations in Germany. Table 3 shows that from 1997 until 2007 relative household and bank ownership of publicly listed companies decreased by about one quarter; relative government ownership even decreased by nearly two thirds. In contrast to the findings of Vitols (2005), the updated Deutsche Bundesbank data of 2008 no longer suggest that insurance corporations have increased their equity holdings in relation to other groups. In fact, their relative ownership has decreased by over one half. Non-financial corporations and the group ‘other financial’ (mainly mutual funds which are ultimately owned by households) have increased their relative shareholdings slightly. Foreign investors have increased their proportion of shareholdings more than any other group. From 1997 until 2007 investors from abroad more than doubled their share from one tenth to over one fifth of all shares issued by German publicly listed

and MDAX indices over the thirty largest German companies that make up the DAX share index.

companies. This means that their relative ownership of 21.3% has become significantly larger than the ownership by banks, insurance corporations and the government combined, which amounted to only 15% in 2007.

Table 3 Ownership structure of publicly listed companies in Germany 1997-2007 (%)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Households	17.3	16.8	16.9	16.8	15.0	14.0	14.9	14.9	14.1	13.8	13.3
Non-financial	37.6	38.0	35.3	37.8	39.5	36.6	36.5	37.3	36.4	36.4	39.3
Government	5.2	3.9	3.6	2.3	1.8	3.1	3.2	3.0	2.3	2.1	1.9
Banks	13.0	12.0	13.0	11.5	11.5	11.2	9.2	9.8	10.6	10.8	9.7
Insurance corp.	7.7	7.2	4.5	4.7	4.9	6.0	5.4	5.1	4.5	4.2	3.4
Other financial	9.0	10.2	12.7	14.4	13.2	14.2	13.4	13.3	13.6	12.9	11.1
Foreign investors	10.1	11.8	14.0	12.5	14.1	14.8	17.4	16.6	18.4	19.7	21.3

Source: Deutsche Bundesbank (2008).

For Germany, these findings seem to contradict the claim by Culpepper (2005, p. 190) that 'however one measures, the largest blockholders in the largest companies have reduced their shares in France and kept them largely stable in Germany.' Although the empirical findings of this study confirm that private investors (individuals and families) have increased their blockholdings during the 1990s until the end of 2008, all other groups associated with patient capital have markedly decreased their blockholdings. Non-financial firms, in particular, have decreased their blockholdings drastically – and not remained stable as suggested by Culpepper.[10] It could be argued therefore that these changes amount to a 'sea change' rather than, as Culpepper suggests, 'the net effect is no change in the extent of patient capital' (Ibid., p. 189-190).

The developments analyzed above are of major importance to the relation between activist hedge funds and German corporate governance Foreign investors are much more inclined to support Anglo-American-style shareholder activism that mostly strives for the creation of short-term shareholder value than traditional German patient capital. The changes in the ownership structure of the 160 largest publicly listed German companies, of which the general

10 That the relative ownership of German publicly listed companies by non-financial corporations increased from 37.6% in 1997 to 39.3% in 2007 suggests that they have strongly diversified their shareholdings.

decline of blockholdings and the rise of *de facto* blockholdings by foreign investors are the most important, have significantly improved the conditions for shareholder activism in Germany. Activist hedge funds have been one of the most influential categories of actors that have exploited this changed institutional configuration of Rhenish capitalism. Before their impact on German corporate governance can be assessed it is necessary to present some vital information on the origin, the historical development and the current state of the international hedge fund industry.

3. Characteristics of the hedge fund industry

The term ‘hedge fund’ goes back to the activities of Alfred Winslow Jones who in 1949 began *hedging* his portfolio of selected, and supposedly undervalued stocks, with short-selling other stocks which he judged to be overvalued. With this method Jones sought to generate high profits, independent from the movement of the overall market. These independent profits are termed ‘alpha’ whereas the overall market movement is termed ‘beta’. Jones also used borrowing additional funds to enhance his returns. This method widely used by hedge funds today is known as *leverage* (Lhabitant, 2007).

3.1. The hedge fund industry in general

There is no universally valid or legally precise definition of the term ‘hedge fund’. In general, a hedge fund is a private and for the most part unregulated investment vehicle, primarily for wealthy individuals and institutional investors which employs alternative investment strategies (Harmes, 2002). In particular, hedge funds are able to follow whatever investment strategies they believe are profitable:

‘They can buy and sell whatever assets or financial instruments they want to, trade any kind of derivatives instrument, engage in unrestricted short-selling, employ unlimited amounts of leverage, hold concentrated positions in any security without restriction, set redemption policies without restriction, and can employ any fee structure and management compensation structure that is acceptable to their investors. In addition, hedge funds have very limited disclosure and reporting obligations, to regulators, the public, and their own investors’ (Edwards, 2004, p. 34).

Due to the rather secretive nature of most hedge funds, the data on the industry remain incomplete. Nevertheless, research indicates that in 2008 at least 50% of hedge funds were legally registered in offshore financial centers (IFSL, 2009). By far most important offshore

domiciles for hedge funds are the Cayman Islands, the British Virgin Islands and Bermuda. These three locations are all British Overseas Territories, which means they enjoy certain autonomy in domestic affairs, such as in tax legislation, but ultimately remain under the sovereignty of the UK. The majority of hedge funds that are not registered in offshore financial centers are located in the USA. In 2008 approximately 70% to 80% of all operating hedge funds were legally registered in territories under the sovereignty of the USA or the UK (IFSL, 2009). Hence, these two countries play a paramount role as the primary legal domiciles of most hedge funds. The dominant role of the USA and the UK for the hedge fund industry is illustrated even more clearly by the fact that in 2008 almost 90% of all hedge fund managers worldwide have operated in the USA (approx. 66%) and the UK (approx. 21%) (IFSL, 2009).

CMEs, primarily Germany, have called for a tighter regulation of hedge funds and private equity funds (also characterized as 'locusts' by some German politicians) during the past decade (Zimmermann, 2008). These highly leveraged capital market focused institutions seemed to require much more oversight, especially after the Long Term Capital Management (LTCM) disaster of 1998: 'For the first time, a hedge fund was deemed 'too big to fail', a status hitherto reserved for countries and large banks' (Lhabitant, 2007, p. 17). The USA and the UK have staunchly opposed tighter international regulation and generally preferred that regulatory authorities keep their 'hands off hedge funds' (Mallaby, 2007). Both countries have internationally advocated the self-regulation of the industry on the basis of non-enforceable codes of conduct.

Since the early 1990s hedge funds have enjoyed phenomenal growth. In 1990 there were about 500 hedge funds with assets of close to $40bn. By mid 2008, however, this number had skyrocketed to a peak of nearly 10,000 funds managing close to $2,000bn.[11] If leverage is included, hedge funds controlled an estimated $10,000bn at their peak in 2008. Thus, total capital under management by hedge funds corresponded to about one-fifth of the market value of the world's listed corporations – although much of it was invested in other assets, such as bonds or derivatives (Mackintosh, 2009). In this regard, hedge funds still represent a rather small part of the overall international financial markets. On the other hand, hedge funds constitute an extremely active class of investors that dominate several important market

11 One of the reasons for this spectacular growth was the fact that hedge funds on average had been able to generate 'alpha' during the dotcom-crash period of 2000-2002 when most other investments slumped.

segments. For instance, hedge funds are prominent actors in the derivatives markets and they account for about 40% of the turnover of major international stock markets (Noyer, 2007). Harmes (2002) highlights the role of hedge funds as market leaders that stems from their ability to unilaterally influence asset prices. Hedge funds are able to do this because of their heavy use of leverage and their ability to concentrate capital in just a few investments. In addition, he finds that hedge funds possess normative authority in the international financial markets which are increasingly characterized by the herd mentality of many managers of mutual and pension funds.

Since the onset of the international financial crisis the global hedge fund industry has faced a roller coaster ride. Unprecedented outflows, weak performance in virtually all market segments and an overall unwinding of leverage have combined to make 2008 the worst year for hedge funds since records began in 1990. However, they still did noticeably better, on average, than the major international stock markets (Gross, 2009). After falling to a nadir of close to $1,300bn in March 2008 the hedge fund industry has since rebounded and predictions by Hedge Fund Research claim that 2009 will become the best year for hedge funds since 1999. This is mainly due to the return of confidence (and therefore leverage as well) to the international financial markets caused by the unparalleled support of governments and central banks around the globe (FAZ, 2009).

Some of the findings presented above are worth emphasizing: Hedge funds come close to being the archetypical short-term investor (Kahan and Rock, 2007); they are pure financial market actors and their success depends to a great extent on liquid financial markets in which they are able to gain high leverage. Thus, hedge funds are one of the most paradigmatic categories of actors representing the LME model where financial markets play a pivotal role for both company finance and (outsider) corporate control. Furthermore, they represent a market stance in which short-term economic goals predominate over long-term ones. The term 'hedge' fund has become misleading, however. More than half a century after Jones pioneered this form of investment vehicle, hedge funds operate on a completely different scale and engage in activities that involve a far greater amount of risk. In fact, during the last decades many hedge funds have not primarily *hedged* the capital entrusted by their investors against losses but have increasingly *speculated* with it, sometimes using extremely risky strategies. Hence, today the term hedge fund is little more than a relic from the beginnings of the hedge fund industry sixty years ago.

3.2. The subgroup of activist hedge funds

Traditionally many hedge funds have pursued arbitrage strategies. This has been rendered increasingly difficult to accomplish as a result of the increased competition generated through the huge increase in the size of the hedge fund industry around the turn of the century. A growing number of hedge funds have since turned to strategies of shareholder activism. However, shareholder activism remains a rather small part of the whole hedge fund industry that also includes strategies of investing in currencies, commodities, bonds or other securities.[12] The subgroup of activist hedge funds tries to create value for their investors by 'improving' the corporate governance of the target firms which will – in their opinion – lead to higher profits and thus to a higher price of the shares they own. In contrast to typical Rhenish share- or blockholders, that represent insider-control, the first and paramount objective of activist hedge funds is the maximization of shareholder value in the short-term by imposing LME-style outsider control on their target firms. Hedge fund activism can be said to comprise three main components. First, activist hedge funds try to increase the market value of the targeted company.[13] Second, they try to benefit from perceived market imbalances or from prices that they believe are out of equilibrium. Third, in many instances activist hedge funds benefit from asset transfers at the expense of other stakeholders in the firm such as workers, suppliers or creditors (Schmidt and Spindler, 2008).

Alone or 'in concert' with other like-minded activist hedge funds, they acquire (initially small) holdings of the voting stock of a listed company and begin to publicly pressure the management to implement their demands. This behavior was aptly called 'wolf pack' tactics by Briggs (2006). The author has identified three typical demands that activist hedge funds have posed to German listed companies to increase (short-term) shareholder value: First, the initiation of a share buy-back program in which the company buys its own shares on the stock market in order to use them for acquisitions or to simply destroy them. In both cases the goal is to increase the share price in the short-term. The second demand is the payment of a special dividend to investors either taken from 'surplus' capital of the company or even by raising debt for this purpose. The third demand is the sale of a division not deemed to be part of the 'core competencies' of the company.

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12 Kahan and Rock (2007) cite a J.P. Morgan estimate of 2006 which states that about 5% of total hedge fund assets have been available for shareholder activism.

13 The OECD has defined activist hedge funds in a similar vein as 'investment vehicles that seek, generally through the exercise of voting power or the threat of it, to influence publicly held companies to take actions

A body of literature suggests that the diversification of corporations entails a considerable reduction in firm value, often called the 'conglomerate discount': 'An underlying theme of this literature is that conglomerates tend to misallocate their investment funds by cross subsidizing poorly performing divisions' (Mansi and Reeb, 2002, p. 2167). This line of reasoning is clearly paradigmatic for the LME model with its paramount objective of maximizing profits in the short-term. However, for CME companies diversification makes perfectly sense; although on the one hand it may lower shareholder value, on the other hand it increases bondholder value and – even more important – it substantially lowers firm risk (Ibid). As was shown above long-term low-risk strategies of incremental innovation are a cornerstone of Rhenish capitalism. Thus, the typical demands of activist hedge funds (often followed by demands for the resignation of uncooperative CEOs of the target firms) clearly represent a clash of opposing interests as the governing coalition of insiders (blockholders, banks and labor) traditionally has sought to ensure the stability and the long-term growth of the corporation in the German variety of capitalism, not the short-term maximization of profits that is almost exclusively beneficial to shareholders. Activist hedge funds may therefore be characterized as '*impatient* capital' whose demands are diametrically opposed to the interests of traditional patient capital.

Most studies that have tried to shed light on the consequences of hedge fund activism on corporate governance in the USA and Germany have used quantitative approaches to the phenomenon (Bessler *et al.*, 2008; Boyson and Mooradian, 2007; Brav *et al.*, 2006; Clifford, 2008; Klein and Zur, 2006; Ryan, 2006). A notable exception is the clinical case study by Bessière *et al.* (2009) on the 'battle' of the French IT company Atos Origin against the two Anglo-American activist hedge funds Centaurus and Pardus. All except one of the quantitative studies have analyzed large empirical datasets of between 200 and 400 cases of hedge fund activism. For Germany, the study by Bessler *et al.* (2008), which is based on a sample of 324 events between January 2000 and June 2006, finds evidence that the engagement of activist hedge funds in the target firms resulted in increased short and medium-term shareholder value. Furthermore, they find indications that the reputation of the activist investor may play an important role – at least for higher short run returns. For the USA, the most important findings include that the short-term (a few weeks) and medium-term (one year) stock performance of the target firms has been higher than that of comparable firms

that the hedge fund believes will increase the companies value' (OECD, 2007, p. 12).

which have not been targeted by activist hedge funds. These funds have had a high success rate of 60% in achieving their original objectives (Klein and Zur, 2006). Furthermore, their study reveals that the average target firm of activist funds has significantly increased its long-term debt load, while doubling dividends and significantly decreasing both its short-term investments and its cash position. Brav *et al*. (2006) find that target firms of activist hedge funds have shown increased operating performance and payout as well as higher CEO turnover after activism. Boyson and Mooradian (2007) report that the targets of hedge funds generally have been small, undervalued firms which have had large amounts of cash. In addition, they find that activist hedge funds have stayed active for over two years and that they have acquired an average blockholding of 17% of outstanding shares of the company. They conclude that 'hedge funds can facilitate long-lasting changes in corporate governance, cash flows, and operating performance that benefit target firm shareholders and hedge fund investors alike' (Ibid., p. 1).

These quantitative studies perceive activist hedge funds primarily as a potential remedy to the classic corporate governance problem of the separation of ownership and control in publicly listed corporations. This separation potentially leads to agency conflicts between the managers and the shareholders of publicly listed firms (See Berle and Means 1932; Jensen and Meckling 1976; Fama and Jensen 1983). Possible consequences for the socio-economic system as a whole are not addressed by these studies. Hence, the foci of the studies described above and the one of this paper differ significantly.

4. Hedge Fund Activism in Germany[14]

In contrast to these econometric studies, this article applies a qualitative lens to the operations of activist hedge funds in order to gain novel insights about the consequences that this phenomenon might have on the socio-economic system of Rhenish capitalism.

4.1. The targets of hedge fund activism

For this purpose ten stockmarket-listed corporations have been studied in which activist hedge funds have invested between 2001 and 2009 in order to analyze the consequences that such

14 High-profile cases of hedge fund activism in other continental European political economies include TCI & Atticus vs. ABN Amro, Centaurus & Paulson vs. Stork and Ahold in the Netherlands, and Pardus vs. Valeo and Pardus & Centaurus vs. Atos Origin in France. See (Bessière *et al*., 2009) for a study of the latter case.

funds have had on Rhenish capitalism.[15] The three typical demands to increase short-term shareholder value are displayed in Table 4 along with the shareholdings of the activist hedge funds in the particular target firm. Furthermore, the presence or absence of a Rhenish blockholder (representing patient capital) is indicated. In many cases a few hedge funds cooperated in order to gain more influence. The total holdings of hedge funds can only be estimated in some of these cases (e.g. Münchener Rückversicherung and Daimler) as individual shareholdings in German listed corporations only have to be revealed if they exceed the threshold of three percent. The cell of the party with the larger shareholding is indicated in grey as it can be reasonably expected that this party will prevail in the case of a conflict of interests. Again, it must be borne in mind that the average voting presence on AGMs of German listed companies has been around 50% during the last decade (Licharz, 2008). This means that a party holding 25% of voting stock is able to win any simple-majority votings – if there is no second party holding a larger share, and the remaining ownership is widely dispersed.

The ten publicly listed companies included in this study can be separated into two groups. One group comprises five companies in which the activists have held larger stakes than Rhenish blockholders (i.e. in which impatient capital has outweighed patient capital). These corporations are: Balda, Daimler, Deutsche Börse, Kuka and Münchener Rückversicherung. Rhenish blockholders have held larger holdings than their hedge fund counterparts in the other group comprising the five German companies: CeWe Color, Curanum, Heidelberger Druckmaschinen, Rheinmetall and Salzgitter.

The cases of CeWe Color, Curanum and Salzgitter are unambiguous. Clearly identifiable Rhenish investors (one founding family, one Landesbank[16] and the German state of Baden-Württemberg) have held *de facto* or *de jure* blockholdings that have been decisively larger then the holdings of the activist hedge funds. Despite vocal demands by the activists to

15 Research by the author at the archive on hedge fund and private equity fund activity in Germany, maintained by the Hans-Böckler-Foundation, revealed these ten cases as the ones most often reported in the major German newspapers. Research using the Lexis-Nexis database has confirmed this finding.
Excluded have been cases in which a merger was pending, as a strategy of merger-arbitrage is generally not driven by concerns regarding corporate control. The same is valid for distressed debt and debt-equity swaps. (Such cases include Techem, Schefenacker, Wella, DIS and Dürr.)

16 The seven German Landesbanken are internationally operating credit institutions which also function as umbrella organizations for the municipally-owned savings banks in their regions. The Landesbanken are mostly owned and controlled by one or more German Länder (states).

increase (short-term) shareholder value these three firms did not implement any of the three typical measures. The Rhenish blockholders have acted clearly along the lines of the patient capital paradigm. They have stressed the importance of long-term business strategies and they have advocated the preservation of elements that contribute to the reduction of firm risk, such as diversification of company activities and the holding of substantial cash reserves. Heidelberger Druckmaschinen and Rheinmetall are more complicated cases because the traditionally Rhenish blockholders Allianz and Röchling turned out not to be so 'Rhenish'. They did not oppose the activst hedge funds but instead used the appreciated share price induced by them to sell parts of their holdings with a handsome profit. Hence, Allianz and the Röchling family (which sold its entire Rheinmetall stake in 2005) have defected from the traditional institution of patient capital in these two cases.

Table 4: Ten major cases of hedge fund activism in Germany between 2001 and 2009

Firm name (Years)	Share-buyback-program	Special dividend	Sale of divisions	Shareholding of activist hedge funds (impatient capital)	Rhenish blockholders (patient capital)
Balda (2007-2008)	No	No	***Yes***	Up to 20%: Audley Capital 10%, Wyser-Pratte 5%	No
CeWe Color (2006-2007)	No	No	No	Up to 25%: K Capital, Marcap, Wyser-Pratte	ACN 27%, NORD/LB 7,8%
Curanum (2007-2008)	No	No	No	Wyser-Pratte 5%	NORD/LB 13%
Daimler (2007-2009)	***Yes***	No	No	Approx. 10% to 15%	No
Deutsche Börse (2004-2009)	***Yes***	***Yes***	***Yes***	Approx. 30%: TCI, Atticus, Lone Pine	No
Heidelberger Druckm. (2005-2007)	***Yes***	No	No	Centaurus 5%	RWE 10%, Allianz 12% (still 'Rhenish'?)
Kuka (2004-2007)	***Yes***	No	***Yes***	Up to 25%: Wyser-Pratte 10%, K Capital, 5%	Landesbank Baden-Württemberg 5%
Münchener Rückver. (2007-2009)	***Yes***	No	No	Approx. 10% to 15%:	No
Rheinmetall (2001-2004)	***Yes***	No	***Yes***	Wyser-Pratte 6%	Röchling family 66% (still 'Rhenish'?)
Salzgitter (2008)	No	No	No	TCI 3%	State of Lower Saxony 26%

Sources: Financial Times Deutschland, Hoppenstedt Firm Database, OnVista and company websites.

The second group comprises all cases in which activist hedge funds have held larger stakes than Rhenish investors. These companies include Balda, Deutsche Börse and Kuka – as well as Daimler and Münchener Rückversicherung. Here the activists have been very successful in demanding the implementation of measures to increase short-term shareholder value. Not every target firm has implemented all three typical demands. As Table 4 shows the set-up of a share buy-back program has been the most often implemented measure with four out of five cases. Balda is an exception here, because the company was in such a bad shape financially that the set-up of a share buy-back program or the paying of a special dividend would have threatened the survival of the firm – even in the immediate short-term.

Although hedge funds in general are very secretive regarding the supply of information concerning their operations, activist hedge funds deviate drastically from this behavior when they initiate a new activist campaign on a target firm. Most of their demands to the management of the target firm are communicated via the media in order to increase publicity. This is of utmost importance to their strategy, because it is likely to increase the pressure on the company management and it will increase the probability that other (institutional) investors will join their activist campaign ('wolf pack' tactics). The greatest publicity by far has been generated by the case of Deutsche Börse – even described by one observer as the 'Deutsche Börse Affair' (Watson 2005). The two Anglo-American hedge funds TCI (The Children's Investment Fund)[17] and Atticus, supported by other hedge funds (e.g. Lone Pine) and Anglo-American institutional investors (e.g. Fidelity, the world's largest mutual fund company), have acquired a cumulative stake of about 30%[18] and forced Deutsche Börse to abandon the proposed takeover of the London Stock Exchange. Instead they have demanded the company distribute all available capital to its shareholders, in the form of a share buy-back program and via a special dividend. The activists have been successful with all but their most extreme demand to sell integral divisions of the corporation to competitors abroad, an act which would have resulted in the virtual break-up of the company. The only division that was sold has been the relatively small IT division called Entory. As Deutsche Börse is a very

17 The name is based on the fact that a portion of TCI's fees go to The Children's Investment Fund Foundation (CIFF), a non-profit organization that 'aims to deliver large-scale, long-term transformational advances for children' primarily in Sub Saharan Africa and India (http://www.ciff.org/content/view/13/27/). However, most of CIFF's assets are reinvested with TCI (Timmons, 2008).

18 There have been many accusations that the combined stake of the investors acting 'in concert' lead by TCI and Atticus was actually over 30% and they would have had to make a public offer for the outstanding shares (cf. fn. 6). However, the circumstance of 'acting in concert' is very difficult to prove legally (Seifert, 2006).

important coordination service firm for the German economy, the German government has intervened rhetorically to stop such plans. The state of Hesse, has been especially vocal and even threatened to withdraw the license to operate the Frankfurt stock exchange (FTD, 2008). The Risk Limitation Law ('Risikobegrenzungsgesetz') of 2008 can be seen as a state reaction to this unwelcome hedge fund activism – yet a mild one. The regulations concerning 'acting in concert' have been both extended and specified (but the circumstance still remains very difficult to prove legally) and investors are now obliged to publicly state their intentions regarding their investment after crossing the threshold of ten percent of company shares (cf. Engelen *et al*., 2008) (again, this is will prove to be a very vague circumstance in legal terms and therefore will do little to constrain activist hedge funds).

The two cases of Daimler and Münchener Rückversicherung are particularly informative, as here there have been only rumors that several activist hedge funds had invested in them (i.e. the individual hedge funds remained under the reporting threshold of three percent). In what could be called 'anticipatory obedience' to the hedge funds, Münchener Rückversicherung has initiated a program to increase company efficiency called 'Changing Gear'. This program has included a share buy-back program, a raised dividend and a plan to increase M&A activity. Facing the threat of shareholder activism, Daimler has initiated a share buy-back program as well. Furthermore, protection against hostile engagement of activist hedge funds has played a major role in the search for a stable 'anchor-investor'. The result has been that the sovereign wealth fund Aabar, that is owned by the emirate of Abu Dhabi took a 9.1% stake in Daimler (Kazim and Zand, 2009).[19]

4.2. The impact of hedge fund activism

These two cases are indicative of the fact that Anglo-American activist hedge funds have exerted 'disciplinary power' over Daimler and Münchener Rückversicherung, two of the largest German corporations that had not been shielded by Rhenish blockholders. Foucault (1986[1976]) coined the term 'disciplinary power' – although he applied it in a completely different context. For him disciplinary power is 'a type of power which is constantly exercised by means of surveillance rather than in a discontinuous manner by means of a system of levies or obligations distributed over time. It presupposes a tightly knit grid of material coercions

19 Kuwait has been a large non-activist shareholder in Daimler since the 1970s. This could be an indication that sovereign wealth funds from the Gulf region are more akin to patient capital than to impatient capital.

rather than the physical existence of a sovereign.' (Ibid., p. 239). This concept of power can very fruitfully be applied to the context of hedge fund activism. Activist hedge funds have contributed to the creation of a market for (hostile) corporate control in Germany. In this respect the many funds that constitute this market can be seen as constantly surveilling the German stock markets for corporations that offer the potential for the creation of short-term shareholder value, and that are not protected by Rhenish blockholders. Since the turn of the century this impatient capital has been able to create an increasingly *tightly knit grid of material coercions* for German listed corporations that do not have protective blockholders. This has forced these companies to adopt measures to maximize short-term shareholder value because activist hedge funds have represented a credible threat to corporate control.

Activist hedge funds have gained a strong reputation through high-publicity cases such as the 'Deutsche Börse Affair'. The fact that they have been able to gain high leverage and that they have regularly acted 'in concert' with other hedge funds ('wolf pack' tactics) have contributed to their credibility as (transnational) agents of change towards outsider control and short-term shareholder value maximization. That other institutional investors, such as investment or mutual funds, have joined the activist campaigns is an indication for the normative authority of hedge funds as described by Harmes (2002). Brav *et al*. (2006, p. 1774) have assessed the influence of activist hedge funds in a similar way: 'The presence of these hedge funds and their potential for intervention exert a disciplinary pressure on the management of public firms to make shareholder value a priority'.

By mid-2009, however, there were indications that activist hedge funds might find it harder to 'rebound' than the overall hedge fund industry. Major activist hedge funds such as TCI, Atticus, Cerberus Capital and Steel Partners reported the closure of some of their individual funds or high redemption requests (Jones, 2009). This has arguably created a (temporary) rupture in the tightly knit web of material coercions that they have been able to create since the turn of the century, simply because they have less capital (and less leverage) at their disposal. On the other hand, impatient capital does not seem to have lost much of its fundamental disciplinary power over German publicly listed companies that do not have a protective Rhenish blockholder. In September 2009 the CEO of Deutsche Börse, Reto Francioni, said in an interview that he was actively looking for protective 'anchor investors' such as the state of Hesse, the federal development bank KfW or sovereign wealth funds,

because he is still worried about ‘attacks from Anglo-American investors’ (Palan, 2009). He made these comments even though the ‘wolf pack’ lead by TCI and Atticus has reduced its combined stake in Deutsche Börse from a peak of about 30% in 2005 to just over 3% in mid-2009.

Another way in which activist hedge funds could have functioned as transnational agents of institutional change is what Culpepper (2005, p. 181) has called ‘joint belief shift’:

‘Joint belief shift constitutes the process by which actors use transformative events to establish a shared perception of the new causal models that underlie their strategic interaction. It is a process initiated by a structural shock, such as the increased opportunity cost of holding large blocks of capital brought on by expanding equity markets’.

Jackson and Höpner (2001; 2006) have argued that the hostile takeover of the German conglomerate Mannesmann by the British firm Vodafone in the year 2000 represented a transformative event for the German system of corporate governance that had traditionally been characterized by the absence of hostile takeovers. In retrospect, the Mannesmann takeover has not been *the* decisive event that immediately triggered a wide-scale sell-off of blockholdings, but it represented a very important element that contributed strongly to an already ongoing joint belief shift in the German political economy. Culpepper (2005) has argued that Mannesmann was unusual for German corporate governance as its shares have been highly dispersed. However, as shown above, blockholdings in general have declined notably since the 1990s and the ownership structures of large German corporations can change quite rapidly. Whereas at the end of 2000 Deutsche Börse was completely held private by the large German banks, at the end of 2001 institutional investors from the USA and the UK accounted for 24%. And again one year later Anglo-American investors already held 45% of voting stock. Finally, at the end of 2005 they held a dominating 77% of Deutsche Börse (Watson, 2005).

Jürgens *et al.* (2000) have convincingly argued that, due to the fact that financial markets still play a limited role for company financing and private household savings, the base for a shareholder value economy is comparatively narrow in Germany. However, the mechanism of ‘joint belief shift’ is able to affect actors that are not directly exposed to the equity markets. In the words of Lane (2003, p. 93), there is ‘pressure for isomorphic adaptation which emanates

from the example of the large flagship companies, the business press and consultancy firms.'

The institutional change provoked by the 'displinary power' of activist hedge funds and the 'joint belief shift' they have been catalyzing corresponds to 'displacement', one of five broad modes of gradual but transformative change identified by Streeck and Thelen (2005). In the context of this study this mode of institutional change comprises both displacement through 'invasion' and displacement through 'defection'.[20] Displacement through invasion refers to the 'supplanting of indigenous institutions and practices with foreign ones' (Ibid., p. 21) from the outside. Conversely, displacement through defection occurs when 'growing numbers of actors defect to a new system, [and] previously deviant, aberrant, anachronistic, or 'foreign' practices gain salience at the expense of traditional institutional forms and behaviors' (Ibid., p. 20). The German political economy after the year 2000 has been the focus of this study. Here, both modes of institutional change have come together. This is related to a point made by Deeg (2005), that if endogenous forces have prepared the ground, it is much easier for external actors (or 'invaders') to induce fundamental transformation. On the other hand, internal actors (or 'defectors') often need activation and support from exogenous forces in order to advance the displacement of traditional institutions.

5. Conclusion

Rhenish capitalism has changed notably since the 1990s. This is due to both endogenous and exogenous factors. Endogenous factors include new reform legislation that has facilitated the unbundling of the dense network of crossholdings and a general decline in blockholdings held by Germany-based investors. The empirical study of the 160 largest listed German corporations by the author has shown that from the early 1990s to the end of 2008 the proportion of companies that have a *de jure* blockholder has declined by nearly 30 percentage points to 56.25%. When looking at *de facto* blockholdings it is remarkable that foreign investors hold such stakes in 17.5% of these 160 companies. Exogenous factors that have influenced Rhenish capitalism include rating-agencies, international accounting standards, and transnational law firms. This article has focused on how activist hedge funds – largely unregulated and highly leveraged investors of Anglo-American origin – have put pressure on German publicly listed corporations that do not have a protective Rhenish blockholder to

22 See (Hall and Thelen, 2009) for more about the institutional change of defection in coordinated market economies, particularly in Germany.

increase short-term shareholder value. In contrast to the institution of patient capital that has been typical to this socio-economic system, activist hedge funds may be characterized as *impatient* capital. The drop in blockholdings since the 1990s has increased the room to maneuver for this impatient capital, as fewer and fewer German companies have been shielded by Rhenish blockholders. Bessler *et al*. (2008, p. 24) draw similar conclusions: 'Hedge funds are able to fill the control vacuum created by the withdrawal of banks'.

The 'Deutsche Börse Affair' (Watson, 2005) which gained much publicity in Germany and beyond was an influential precedent for the power of activist hedge funds. In fact, since 2001 activist hedge funds have been able to successfully implement measures to create short-term shareholder value in a number of companies that did not have a Rhenish blockholder. Furthermore, there have been signs for an emerging 'disciplinary power' of activist hedge funds over German publicly listed corporations that feature a dispersed share ownership structure. The reason for this is that the highly-leveraged activist hedge funds 'acting in concert' ('wolf pack' tactics) have increasingly represented a credible threat to such companies that opposed measures to increase short-term shareholder value. In this vein, these private economic actors of Anglo-American pedigree have functioned as transnational agents of institutional change towards a system of outsider control that is characteristic of the LME model. In addition, activist hedge funds have arguably contributed to an ongoing 'joint belief shift' within the German political economy towards the shareholder value paradigm and outsider control. Anecdotal evidence for this is the defection of Allianz and the Röchling family from the traditional institution of patient capital in the cases of Heidelberger Druckmaschinen and Rheinmetall. Although the international financial crisis has left its mark on hedge funds, the industry has since rebounded strongly and activist hedge funds do not seem to have lost much of their fundamental disciplinary power over publicly listed German companies that are not shielded by a Rhenish blockholder.

Insider control, stability, diversification, low-risk strategies and long-term cooperation have played important roles for corporations within Rhenish capitalism. The typical demands by activist hedge funds – the initiation of a share buy-back program, the payment of a special dividend and the sale of divisions that are not part of the 'core competencies' of the company – are diametrically opposed to these elements. Hedge fund activism is imposing outsider control that seeks to maximize shareholder value in the short term. Hence, by discouraging

long-term low-risk business strategies of many German firms activist hedge funds have the potential to erode central elements of this socio-economic system in the future.

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