NO EXIT!: THE LOGIC OF DEFENSIVE SHAREHOLDER ACTIVISM

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Abstract

This paper examines the issue of what motivates shareholder activism. The standard explanation portrays shareholder activism as a response to poor corporate performance, but the empirical literature provides inconclusive support, indicating the need for alternative or complementary explanations. This paper contributes to the literature by showing, with the help of a case study, that shareholder activism can also be a response to increasing costs for exiting the investment, making outside shareholders increasingly exposed to expropriation risks. Significant expropriation risk can antecede a defensive type of shareholder activism characterized by intensified monitoring and reactive intervention to fend off expropriation attempts, which differs from the standard explanation in both motivation and outcome.

Keywords: Corporate Governance; Shareholder activism; Transaction Costs; Case Study

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Introduction

This paper examines the issue of what motivates shareholder activism. Outside shareholders can influence corporate insiders either indirectly by trading, thereby affecting stock price, or directly by voicing their opinions in order to affect corporate behavior, i.e. shareholder activism. Shareholder activism has long puzzled spectators because of its seemingly irrational nature. As Hirshman (1970), among others, has argued, when exit possibilities are sufficient, voice typically becomes a residual to exit. Shareholder activism has the character of a public good; an activist shareholder must carry all costs privately, but can capture only a fraction of the benefits (Olson, 1965; Admati *et al*., 1994). Because of this public good quality and easy access to the stock market, shareholders of publicly traded corporations have typically been expected to walk the 'Wall Street walk' and vote with their feet when they are dissatisfied with the performance of a company in their portfolio (Carleton *et al*., 1998).

While exit behavior may be the general case, shareholder activism has grown more common on U.S. stock markets (Useem, 1996; Jensen, 1993; Gillian and Starks, 2000) as well as on European markets such as the Stockholm Stock Exchange (Bengtsson, 2005). This is particularly evident among institutional investors, traditionally regarded as the most reluctant monitors of corporate activities (Coffee, 1991). It is widely believed that shareholder activism is a means by which outside shareholders discipline inefficient management teams (e.g., Cohn and Rajan, 2013; Alchian and Demsetz, 1972; Admati *et al*., 1994; Kahn and Winton, 1998; Maug, 1998). However, as shown by Karpoff (2001), despite numerous studies looking at the characteristics of companies targeted by shareholder activism and the effects of such activism on firm performance, the question of what motivates shareholder activism remains to a large extent unanswered.

This paper starts from the observation that the 'standard explanation' of shareholder activism, depicting activism as motivated by poor managerial performance, fails to account for a large pool of data (e.g., Gillian and Starks, 2000; Karpoff *et al*., 1996; Nelson, 2006; Wahal, 1996; David *et al*., 2007). Alternative hypotheses on what motivates shareholder activism, whether complementing or competing with the typical view, are thus needed. The main contribution of this paper is the identification and description of a type of shareholder activism with slightly different character, and with antecedents that differs from the standard explanation. An extended framework of shareholder activism introduces ideas from transaction cost economics (Williamson, 1985, 1996), showing that outbursts of shareholder activism can be motivated not only by poor managerial performance, but also by increasing costs of exiting an investment in a firm. High exit costs can create incentives for safeguarding the investment against expropriation, prompting what is here termed defensive shareholder activism. Defensive shareholder activism can be seen as a variant of shareholder activism more characterized by intensified monitoring and reactive intervention to irregularities discovered in the monitoring process than the aggressive interventions to accomplish managerial or policy changes typically associated with voice behavior by outside shareholders. Defensive shareholder activism is not necessarily associated with stock price movements, and its prevalence may therefore partially explain the inconclusive results from previous shareholder activism research.

A case study of defensive shareholder activism on the Stockholm Stock Exchange is used to illustrate and support this argument. The case study provides opportunities for an exploration of the types of exit costs that create incentives for defensive shareholder activism and the logic of safeguarding that characterizes this type of activism.

WHAT MOTIVATES SHAREHOLDER ACTIVISM?

Outline of shareholder activism research

Shareholder activism may be defined as voice behavior by outside shareholders, i.e. shareholders that are not represented on the board or top management team, whether this occurs by formal (e.g., filing of proposals) or informal (e.g., private negotiations) channels (cf. Karpoff, 2000). The standard explanation of shareholder activism typically portrays such activism as a response to poor corporate performance. The discussion here is limited to shareholder activism seeking changes generally thought to lead to improved financial performance; however, shareholder activists may also seek to improve other facets of corporate performance such as social or environmental performance (e.g., Judge *et al.*, 2010; David *et al.*, 2007). If a firm is not monitored, insiders are free to pursue their own interests, which may lower the firm's value and thus create incentives for shareholder activism or a hostile takeover (Fama, 1980). By devoting resources to monitoring and interventions, shareholders can bring about changes to policy or management teams and thereby increase the price of the stock (e.g., Alchian and Demsetz, 1972; Admati *et al.*, 1994; Kahn and Winton, 1998; Maug, 1998). In this regard, shareholder activism is similar in function to, though less drastic than, a hostile takeover. Some researchers indeed argue that recent regulation has increased the costs of takeovers, making shareholder activism an attractive substitute (Pound, 1993); others contend that takeovers are a special case of activism – more risky, but with a higher return if successful (Dasgupta and Nanda, 1997).

Large shareholders presumably have stronger incentives for shareholder activism since they are able to capture a larger fraction of the benefits stemming from a raised share price (Alchian and Demsetz, 1972; Admati *et al.*, 1994). Controlling a large fraction of a firm's stock is also likely to increase the probability that the activism will produce the desired result (cf. Olson, 1965). A testable implication of this – and, indeed, the measure of the success of shareholder activism thus seen – would be a positive relationship between shareholder activism and return on the firm's stock, which falls on the activist.

A large number of studies have analyzed the characteristics of firms targeted by activism efforts and the effects of activism on accounting and stock performance. Examples of studies looking into the effects of shareholder activism include: English II *et al.* (2004), and Strickland *et al.* (1996), who record positive abnormal returns stemming from shareholder activism; Wahal (1996), Prevost and Rao (2000), and Nelson (2006), who record negative abnormal returns; and Karpoff *et al.* (1996), who record no significant abnormal returns. Further results are reported in Gillian and Starks (2000), who show institutional shareholder activism to be associated with negative abnormal returns and activism by "gadflies" associated with positive abnormal returns, whereas the results of Clifford (2008) and Brav *et al.* (2008) indicate that hedge funds may be successful in increasing firm value, though this effect might only be short term and valid in certain corporate governance systems (Mietzner and Schweizer, 2014). Carleton *et al.* (1998) and Del Guercio and Hawkins (1999) report that abnormal returns vary with the issue at the root of the activism within a span stretching from negative to positive, and Smith (1996) reports that the sign of the abnormal return depends on whether the targeted firm adopts or resists the issue of contention. Hadani *et al.* (2011) and Sun *et al.* (2013) show how shareholder activism indeed

may precipitate accounting manipulation to create the illusion of improved performance, which the market presumably, given results about abnormal returns, sees through.
The cited studies display differences on many dimensions, to be sure, such as whether they study formal or informal channels of voice, or their definition of event day or window. Karpoff’s (2001) survey of 20 empirical studies on shareholder activism – both informal and formal, and with various definitions of event day and window – does, however, indicate that shareholder activism is not on average associated with abnormal returns, even though targeted firms tend to experience fairly weak performance prior to shareholder activism. Indeed, shareholder activism directed at increasing other-than- financial performance, say, social performance, likewise appears ineffective in bringing about substantial change (David *et al.*, 2007). So while increasing a company's stock or other type of performance may spur some shareholder activism, the answer to the question of motivation remains partly unresolved.

One explanation may be agency problems with the institutional investors, which tend to be shareholder activists; fund managers may, for example, be seeking publicity to further their personal careers (Coffee, 1991; Black, 1992; Nordén and Strand, 2011). Management's compliance with shareholder activists may be symbolic rather than substantive (Westphal and Zajac, 1998), but may nevertheless have positive effects on the activists' image (David *et al.*, 2007). Another contributing factor might be that public knowledge of shareholder activism serves as a signal indicating an entrenched and uncooperative management team (Prevost and Rao, 2000). This paper, however, explores another potential motivation for shareholder activism: increasing costs for exiting the investment (cf. Helwege *et al*., 2012; Coffee, 1991; Bhide, 1993), leading to a type of activism that is not necessarily related to corporate performance.

Towards an extended framework: introducing transaction costs

Liquidity, i.e. the ability to exit a stock position without causing significant price movements, has been suggested as an influence on the propensity for shareholder activism; the direction of the relationship, however, is contested. Coffee (1991) and Bhide (1993) argue that there is a negative relationship between liquidity and shareholders exerting (direct) control, since less liquid markets make it more costly to trade and therefore provide stronger incentives for large shareholders to affect their portfolio return by means of voice (Helwege *et al*., 2012). However, though a less liquid share may create incentives for voice, Edmans *et al*. (2013) argues, it may create disincentives for investors to acquire a position large enough to motivate activism in the first place. Hence, liquidity-seeking institutional investors will tend to avoid reaching a point at which voice becomes rational, since voice tends to be associated with poor liquidity.

This suggests a negative relationship between liquidity and control, but contrary arguments exist. Kahn and Winton (1998) and Maug (1998) contend that greater liquidity produces stronger incentives for shareholder activism aimed at increasing stock performance precisely because it allows for the trading of the stock, the value of which is affected by activism. That large activist funds tend to target large firms with proposals for reform (Karpoff, 2001) could be interpreted as support for the position that there is a positive relationship between liquidity and shareholder activism, since large firms’ stock presumably is more liquid on average.

The relationship between liquidity and shareholder activism, however, may not be as paradoxical as these results suggest. It can be argued, with an analogy borrowed from transaction cost economics, that illiquidity and related costs associated with exiting an investment provide incentives for shareholder activism. However, this type of shareholder activism is not motivated primarily by a desire to increase firm performance and, thus, stock value, for which stronger incentives are at hand under conditions of strong liquidity. This type of shareholder activism is motivated by a desire to safeguard the investment from expropriation.

Williamson’s (1985, 1996) transaction cost economics, with its central concept of ‘asset specificity,’ provides a basis for thinking about this issue. According to Williamson,

> (1) Asset specificity refers to durable investments that are undertaken in support of particular transactions, the opportunity cost of which investments is much lower in best alternative uses or by alternative users should the original transaction be prematurely terminated, and (2) the specific identity of the parties to a transaction plainly matters in these circumstances, which is to say that continuity of the relationship is valued, whence (3) contractual and organizational safeguards arise in support of transactions of this kind. (Williamson, 1985: 55)

If a transaction is characterized by significant specificity, it means that there is a cost for terminating it, namely, the value of the specific investment that is lost by termination. While asset specificity is most often associated with investments in physical or human capital to support transactions, it is here more widely understood as any investment associated with a transactional relationship that loses value if the transaction is terminated.

Buying stock places the investor in a transactional relationship with corporate insiders, and if this investment in equities is characterized by significant specificity, there is a significant cost for exiting. An individual share representing a fraction of this specific equity capital is typically not characterized by significant specificity since it is standardized and generally liquid. Williamson (1985: 304) argues, however, that "what is available to individual stockholders may be unavailable to stockholders in the aggregate". Stockholders, when seen as a collective, cannot easily retract and redeploy their investment; the equity capital is usually retractable from a corporation only at a considerable loss of value by means of liquidation (Collin, 1990; Kärreman, 1999). Under some circumstances, moreover, the costs for retracting a smaller stock position can also be of significance. Poor market liquidity, for example, may contribute to specificity of especially large shareholders' investments, making it costly to sell a large position and thereby retract the investment without a loss of value.

Williamson (1985) argues that barriers to terminating transactions create incentives for shareholders to set up safeguards against expropriation; the more costly the termination, the stronger the incentives. Without costs for terminating transactions, exit is typically the most convenient way to respond to signs of expropriation, but when these costs rise, other responses become more attractive. Hence, increasing specificity of a stock holding may create incentives to devote resources to safeguarding the investment so that corporate insiders are less likely to expropriate the outside shareholders, expropriation from which the 'locked in' shareholder cannot escape. This is the rationale behind defensive shareholder activism.

Offensive and defensive shareholder activism

The previous discussion shows that two types of shareholder activism, each ultimately motivated by the desire to maximize wealth, but by different means, can emerge. These can be called offensive and defensive shareholder activism, respectively, and are summarized in Table 1.

Table 1. Offensive and defensive shareholder activism

	Offensive shareholder activism, the 'standard explanation'	Defensive shareholder activism
Incentive	Opportunity for increased expected return from voice.	Increase in the costliness of exit.
Response	Intervention to realize profit opportunity	Safeguarding against expropriation by insiders

Offensive shareholder activism, so termed because it implies the offensive seizure of an opportunity for realizing value, corresponds to what has been described as the standard explanation of shareholder activism. It can be viewed as related to hostile takeovers, since it is driven by similar objectives, though differing in method (Dasgupta and Nanda, 1997). This type of activism occurs when outside shareholders discover an opportunity to increase firm performance by means of intervention and act upon that opportunity.

Defensive shareholder activism, so termed because it implies the defensive safeguarding of an investment from which the shareholder can no longer easily escape, differs both in motivation and outcome. It is motivated by an increase in the costs for exiting an investment, i.e. increased specificity of the investment, which creates incentives for shareholders to put resources into protecting it from expropriation (Williamson, 1985). Shareholders who experience significant increases in exit costs may find it worthwhile to engage in monitoring insiders and to react to suspicions of expropriation by intervening. Extensive specificity may even, if this is possible, create incentives for shareholders to become insiders, e.g., accept a board seat for purposes of efficacious monitoring, as may often be the case for controlling shareholders. Unlike offensive shareholder activism, defensive shareholder activism is not undertaken as much for the purpose of realizing specific changes in the targeted firm to increase firm value as for the purpose of preventing expropriation.

Similar traits are likely to characterize shareholders engaging in both offensive and defensive activism. The larger the fraction of a firm a shareholder owns, the stronger the incentives for offensive shareholder activism should an opportunity for realizing better firm performance arise. A higher firm value falls equally on all shares, and a large shareholder thus captures a larger fraction of the payoff from such activism (Alchian and Demsetz, 1972; Gillian and Starks, 2000). At the same time, a large position is likely to be less liquid (Coffee, 1991), which may create incentives for defensive shareholder activism. It is also more likely that a large position represents a large portion of a shareholder's portfolio, which strengthens the incentives to devote resources to monitoring the particular firm (Kärreman, 1999). In general, shareholders face stronger incentives for offensive activism if they are able to trade the stock of the target company efficiently (Kahn and Winton, 1998; Maug, 1998). Increased specificity of an investment, which may motivate defensive shareholder activism, discourages offensive activism because it limits the possibility of trading stock and thereby realizing gains.

The following case study evidence is used to explore both the meaning of 'specificity' in the context of shareholder activism and the elements of activism directed at safeguarding an investment. The result is an elaboration of the simple model of defensive shareholder activism outlined above. The case study describes activism that began as a modest offensive effort and, as the study period progressed, responded to increasing specificity by shifting to a logic of safeguarding the investment. It permits a contrast of the two forms of activism for purposes of delimitation. (Illustrative case studies and/or general process descriptions of a purer offensive type of shareholder activism are available elsewhere (e.g., Bruner, 1999; Gillian *et al*., 2000; Useem, 1993; Jansson, 2007; Black and Coffee, 1994; Carleton *et al.*, 1998; Wahal, 1996).

RESEARCH DESIGN

Case studies are generally considered a suitable strategy for empirical enquiry supporting theory development regarding phenomena about which little is known (Yin, 2003; Eisenhardt, 1989; Mintzberg, 1979). This approach is therefore appropriate for elaborating on the rudimentary model of defensive shareholder activism outlined above.

The single case study of how shareholders of the publicly traded Swedish corporation Consilium engaged in shareholder activism was located through searches of a database containing most of the material published in the Swedish business press (Affärsdata). Most of the identified cases of shareholder activism were of the offensive type. Indeed, the Consilium case study was the only example of defensive shareholder activism in the sample. There are good reasons to believe that defensive shareholder activism rarely becomes visible in the media (Jansson, 2007), which may explain why instances of it are relatively difficult to find in media searches.

The Consilium case is particularly useful in that it provides an example of both defensive shareholder activism and the typical explanation of (offensive) shareholder activism prevalent in the literature, permitting a comparison of the two. For this reason, it is the lone case study drawn from and laid out in some detail in this paper. It is a 'critical' case, one with the capacity to make a contribution to theory, justifying the low n characterizing the empirical design (Yin, 2003).

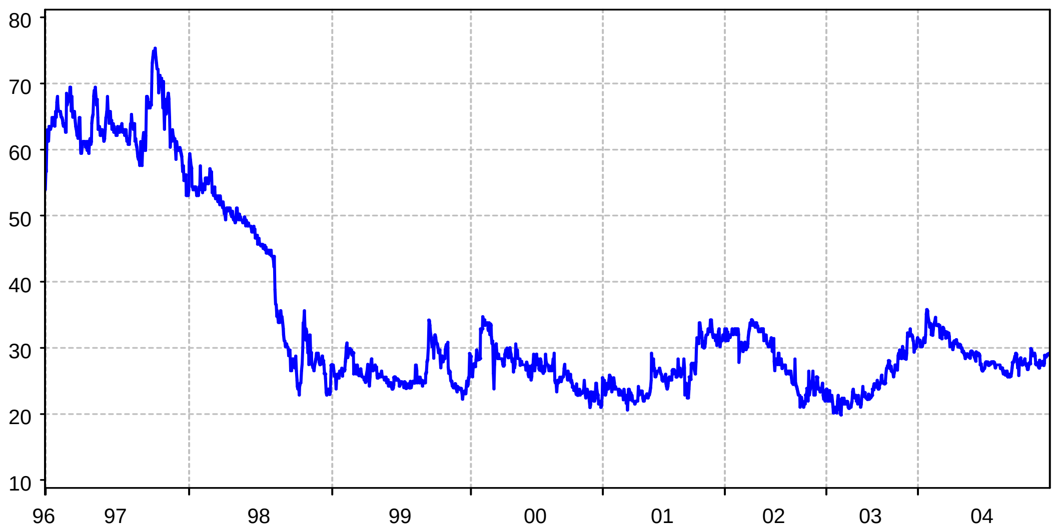
Research setting

The targeted company, Consilium, is a Swedish engineering firm mainly producing marine technology. Some basic data on Consilium for the case study period are presented in Table 2. During the period 1998-2000, Consilium saw a decline in accounting performance, which was also reflected in its stock performance, as shown in Figure 1. After that, accounting performance and share price stabilized at a lower level.

Table 2. Basic data on Consilium

	1998	1999	2000	2001	2002	2003	2004
Total net revenue, SEK million	597.9	569.6	590.5	635.8	650.4	631	593.8
Operational profits, SEK million	11.3	–18.9	–31	7.5	7.4	11.2	11.4
Profits before taxes, SEK million	6	–26.9	–44.3	–8.4	–11.2	–4.3	–2.9
Number of employees (31/12)	467	473	496	460	441	391	401
Turnover rate, B shares (%)	70	32	52	20	8	11	25

Figure 1. Daily price of Consilium B stock (source: Reuters EcoWin)



The company has a majority owner who also is its founder (the Rosenblad family); beyond that, no shareholders had a stake larger than 10 % during the study period. The size of the controlling shareholder and the three shareholder activists involved in the activities throughout the case study period are summarized in Table 3. The level of ownership concentration displayed is pretty typical for a Swedish publicly traded firm, although voting rights are somewhat more concentrated to the controlling shareholder than average. In 1998, the largest owner in firms traded on Stockholm Stock Exchange controlled on average 37.7 % of votes, while the second largest owner controlled 11.2 % (Agnblad *et al.*, 2001).

Table 3. Year-end percentage of Consilium held by the controlling shareholder and the shareholder activists

	1998	1999	2000	2001	2002	2003	2004
The Rosenblad family	34.3 (65.4)	42.5 (69.7)	46.6 (71.9)	47 (72.1)	46.6 (71.8)	47.0 (72.0)	38.6 (64.6)
Sound Invest	2.5 (1.3)	7.7 (4.0)	9.0 (4.7)	9.6 (5.0)	9.7 (5.1)	9.1 (4.8)	4.7 (2.7)
Mr. Hallberg	-	-	4.6 (2.4)	5.7 (3.0)	5.6 (3.0)	5.4 (2.9)	3.7 (2.1)
Mr. Vahlqust	-	2.6 (1.4)	4.0 (2.1)	4.0 (2.1)	4.4 (2.3)	4.7 (2.5)	3.9 (2.3)

Note. Bracketed number is held percentage of votes.

Sound Invest is an investment club, and Mr. Hallberg and Mr. Vahlquist are private, non-professionally occupied investors. In 1998, Sound Invest was the fourth largest shareholder of Consilium. In 1999, it was the second largest, and Vahlquist was the third largest. Throughout 2000-2003, Sound Invest was the second largest shareholder, Hallberg the third largest, and Vahlquist the fourth largest. The company's stock is dual class; the Rosenblad family owns stock with greater voting power than that of other shareholders, giving it a voting stake that is larger than its capital stake.

At the outset of the study, the head of the Rosenblad family (Mr. C. Rosenblad) also held the position of CEO of Consilium. The company can thus be described as under tight family control, which is common for publicly traded corporations in Sweden (Agnblad *et al.*, 2001; Jonnergård and Kärreman, 2004) and in Europe more generally (La Porta *et al.*, 1999).

Data collection

Three sources of data were used: personal, semi-structured interviews with the shareholder activists and board members of Consilium; press material including press releases documenting, for example, activists' and insiders' public appearances; and data on the targeted firm from various public sources. The main source of empirical data was, nonetheless, the personal interviews, which were completed during the spring-summer period of 2004. All in all, five interviews ranging from 1.5 to 2 hours, three with involved shareholder activists and two with board members, underlie the case study. All interviews were conducted face to face, recorded and transcribed.

The interviewees were given the opportunity to review the interview transcripts, quotations and extensive case descriptions to increase the construct validity of the data (Yin, 2003). Only a handful of comments on very specific issues were received, resulting in minor changes. The low level of feedback could be interpreted as a sign that the case study data and descriptions were of incontestably high quality or that the respondents did not have the time or urge to ensure their accuracy. In any case, those who made comments had evidently browsed the material, suggesting that errors or misinterpretations were rare.

Data analysis

The interviews aimed at capturing descriptions of the shareholder activism from the perspectives of the respondents. Most of the interview data were of a retrospective nature, creating the potential for biases arising from, for example, post-event rationalization and poor recall. A number of techniques were used to counter these problems. The multiple sources of data allowed for triangulation of key case study facts (Yin, 2003), especially for events involving Consilium that were deemed potentially important to the investment community at the time. These could usually be corroborated by press material and other data sources such as annual reports. Having multiple informants, both insiders (board members) and outsiders (shareholder activists) to the firm, describe the same process made it possible for the interviewees to corroborate each other's narratives.

The initial phase of analytical work consisted of a rather unstructured interplay between descriptive empirical material and theory, allowing for exploration of patterns in the empirical material and the development of novel theoretical propositions (cf. Mintzberg, 1979). The basic model of defensive shareholder activism was formed at this stage, fuelled by the differences between the Consilium case and other cases of offensive shareholder activism being studied at the same time.

Once the basic theoretical concepts and relationships had been specified, a more structured phase of analytical work began. The basic theoretical concepts formed categories to which empirical data were assigned following a close reading of the material. Through this open and presuppositionless linking of empirical data to theoretical concepts, operational indicators captured by the theoretical concepts were, to some extent, induced by the data. The Consilium case was at this stage contrasted with the other case studies of offensive shareholder activism. The identified indicators were consistently used across the cases, leading to the identification of the idiosyncrasies of defensive shareholder activism. To ensure construct validity, multiple indicators were sought and used for key theoretical concepts such as asset specificity. To the extent that the basic theories could not capture presumably important empirical data, new categories were formed and used for explaining the outcome of individual cases or variations across cases. The analysis can thus be described as consistent with Eisenhardt (1989): first, a case-by-case analysis in which theoretical explanations of the individual cases of shareholder activism were developed, and then a cross-case analysis focusing on variations.

CASE STUDY: FROM OFFENSIVE TO DEFENSIVE SHAREHOLDER ACTIVISM AT CONSILIUM

Initial offensive shareholder activism at Consilium

The history of shareholder activism at Consilium involves encounters of a more offensive type, which preceded the defensive activism that is the main focus in the case study. In the mid 1990s, a group of Consilium shareholders frequented an Internet-based forum for discussing stocks. In the latter part of the decade, discontent began to spread because of declining stock performance (see Figure 1). The forum discussions led these outside shareholders to conclude that Consilium was too diversified and that this explained its poor performance. Two Consilium shareholders, one representing an investment club (Sound Invest, represented by Mr. Andersson, the club's chief of investments) and the other (Mr. Palmqvist) acting on behalf of privately owned stock, were active participants in the discussions and articulated the group's consensus in a letter sent to the board of Consilium prior to its 1998 annual general meeting. The letter put forward their view on why the company's performance was poor and presented concrete suggestions for improving the company's strategy to increase the firm's value. Approximately 30 other shareholders who had participated in the Internet discussions also signed the letter.

This action fits the general characterization of offensive shareholder activism: shareholders, motivated by a firm's poor performance, attempt an intervention to bring about changes that they believe will lead to improved performance. The activists had strong faith in Consilium's (core) products, yet both profits and stock performance fell. According to Fligstein (2001), the late 1900s saw a shift in strategic wisdom among U.S. publicly traded firms away from the notion of diversification as a good way to spread risk towards an ideal of focusing on 'core competences.' A similar line of thinking was applied by the shareholder activists, who, aware of Consilium's poor performance and diversified corporate structure, saw an opportunity to increase the company's performance by decreasing its diversification, i.e. an opportunity to increase stock performance by intervening with a shareholder proposal.

The two initiators of the letter attended that 1998 general meeting and discussed the issues with Consilium's controlling shareholder. That was the beginning of a lasting relationship, as described below:

> But they got into trouble with margins in some business areas and with stiffening competition, and so on. And they were a bit too diversified in their structure and simply had too many business areas. So when we already had bought 550,000 shares, we were not happy with the development. It got so that we'd usually contact the CEO, primarily, but also eventually the chairman of the board, more and more often, because we began to worry simply what would become of this investment. [Mr. Palmqvist]

Palmqvist joined Sound Invest after this incident and eventually replaced Andersson as chief of investments. As shown in Table 3, the investment club's stake increased because, according to Palmqvist, they considered Consilium a future turnaround candidate; in 1999, it was the second largest shareholder of Consilium, second only to the controlling family.

Following that annual meeting, triannual meetings of representatives of Sound Invest, members of the controlling shareholder, and the CFO (Mr. Hansson) took place at Consilium headquarters in Stockholm. In 2001, Consilium's third largest shareholder, Hallberg, who had approached Palmqvist on the Internet-based forum, joined these meetings. The head of the Rosenblad family had resigned as CEO the previous year, replaced by the former CFO Hansson, and had taken on the role of chairman of the board while retaining an operational role in Consilium. The issues discussed at these meetings of the shareholder activists and Consilium insiders centered not only on the desirability of focusing on Consilium's core activities, but also on how to interpret public data concerning the company.

Changing incentives: closing window of opportunity and increasing specificity

The incentives facing the shareholder activists of Consilium gradually changed. The new CEO began focusing the corporate structure and subsequently divested periphery businesses. (The process had almost been completed at the time of the interviews.) At the same time, the activists were facing increasing specificity of their stock, especially after 2000. Two factors affected their perceived cost of terminating their Consilium investments: the liquidity of the stock, and investment in specialized human capital.

Consilium stock suffered from declining liquidity throughout the case period. This is illustrated by the declining turnover rate of the stock (see Table 2). Turnover rate dropped from 70% in 1998 and hit bottom with a rate of 8% in 2002. Although turnover on the Stockholm Stock Exchange fell generally during this period, with the exception of stock with higher voting power (typically not traded to any significant extent), Consilium stock had the lowest turnover rate on the exchange's A list, where it was quoted in 2002. On the Stockholm Stock Exchange as a whole, including also the O list with smaller and less established firms, Consilium ranked among the 10% least liquid stocks as measured by turnover rate. For Sound Invest, this meant that daily turnover of the stock in 1999 was the equivalent of 8.5% of its position; in 2001, it was down to 0.9%; and in 2003, it was 0.4%. Had Sound Invest been the only seller of Consilium stock in 2003, the trading volumes at hand would have forced it to allow for 250 trading days to liquidate its position.

Declining liquidity makes it more costly for a large shareholder to use the exit mechanism, since stock price will be depressed if large numbers of shares enter the supply side of the market. Thus, in the case of Consilium, the ability to sell a large position without affecting stock price sharply declined during the case period, making monitoring more attractive (Coffee, 1991; Bhide, 1993).

Throughout this time, the activist shareholders continued to invest in human capital specific to Consilium, i.e. they invested significant amounts of time and effort learning about Consilium and its markets, building a bank of knowledge that would be virtually useless in the event of exit. This was confirmed through multiple sources. The controlling shareholder, for example, described the activists as "tremendously knowledgeable," and the activists consistently reported spending numerous hours taking in and processing information relating to Consilium and its markets. As the following quotation suggests, such investment can be thought of as a cumulative process, and the resulting human capital must be signaled to insiders if an outside shareholder is to make a difference in operational issues.

> Initially you will have to be rather modest in your appearance, [about] what you think should change. But subsequently, as you get the respect, you start making demands. … [Affecting a firm in a certain direction] is [all about] attempting to convince. It is as always to try to get people to share your opinions, and that can take a very long time. [Mr. Hallberg]

That the activist shareholders undertook significant investment in specialized human capital is also consistent with the observation that Consilium was either by far the largest (for Sound Invest) or the third largest (for Hallberg) investment and thus took up a large part of the activists' portfolios, which were generally relatively undiversified. A well-diversified shareholder rarely has any incentives to devote resources to monitoring, much less investing in specialized human capital relating to any specific firm in the portfolio (Fama, 1980). However, a shareholder with a portfolio in which one firm dominates has stronger incentives to monitor this particular firm on which so much of her/his personal wealth depends (Kärreman, 1999).

Developing human capital specialized in issues relevant to a given firm increases monitoring capacity. This is particularly valuable when liquidity falls and the investment cannot be escaped without cost, since effective monitoring serves as a safeguard. However, it also increases the cost of liquidating the investment, since the specialized human capital yields no economic value when it cannot be used for ensuring the efficiency of the management of one's invested capital.

There are indications, then, that the specificity of these shareholders' investment in Consilium increased in the period following 2000. The significance of the increasing exit costs is revealed by what happened at the end of the case period. In 2004, Consilium engaged a liquidity provider, guaranteeing that the stock would be liquid against a fee. This can be viewed as a natural experiment testing whether prior poor liquidity had any behavioral consequences for the shareholder activists. Both Sound Invest and Hallberg divested significant portions of their stock positions (38% and 16%, respectively) in the year the liquidity provider became available, indicating that the lowering of exit costs indeed had behavioral consequences. Parallel to this process, the situation that motivated the initial offensive shareholder activism gradually disappeared as the corporate structure became more focused. This change in incentives was reflected in the activists' activities *vis-à-vis* the firm.

Changing activism behavior: intensification of monitoring activities with the option to intervene

The shareholder activists responded to the changing incentives by gradually placing more emphasis on monitoring and less on pushing for concrete changes. The third largest minority shareholder, Mr. Vahlquist, joined the two activist shareholders previously mentioned as a participant in the meetings with the controlling shareholder and CEO, and the content of those meetings reflected this changing emphasis. The activists started monitoring the performance of Consilium more generally, discussing how publicly released data should be interpreted, demanding projections on future performance, and trying to hold insiders accountable for meeting targets. The following excerpts reveal both the character of these meetings and the increasing emphasis on monitoring rather than securing changes designed to add value to the firm.

> I think it has been enough for them to know that we are there. They know what we think, that we think the transformation [of the corporate structure] should happen at [a quick] pace. And it feels as though it has been enough that we have been behind the scenes, and [that] we have a meeting to check with them from time to time. [Mr. Palmqvist]

> Generally we have made a small list [of topics to cover at the meetings]. In particular, if something was a negative surprise in a quarterly report, or … [in] monthly accounts of sales figures and backlog. Especially if there is something that deviates from earlier prognoses, we attempt to squeeze out of them why these deviations happened. [Mr. Vahlquist]

The activists were no longer pushing for concrete changes, but were engaging in safeguarding their investments. Safeguarding is reactive in nature, consisting of monitoring and responding to the steps taken by corporate insiders. In this way, the activists shifted to a defensive type of shareholder activism; their objectives moved towards reducing risk rather than increasing reward.

Processing information was one of their main risk-reducing measures. The group effectively operated as a 'gatekeeper' in the same sense as an analyst who specializes in a specific firm (Coffee, 2006), but with strong incentives to discover and act upon expropriation risks since these would hurt them personally. The three activists were the only outside shareholders with significant holdings, which often is thought to provide an informational advantage vis-à-vis other shareholders (Schnatterly *et al*., 2008). The following quotation illustrates not only how the attainment of soft information from insiders, but also how economies of scale in information processing helped the group more effectively monitor Consilium.

> When they rang me, it was before one of these meetings, and they asked if I wanted to participate, and I wanted to. … It was rewarding to share their assessments [on company-related issues]. It was important as a supplement to the information given by the management

> of Consilium to get two other actively interested owners' assessments of everything. [Mr. Vahlquist]

Monitoring is unlikely to result in behavioral changes if identified misbehaviors are not punished in a way perceived by the monitored entity as costly. Should that entity be a professional management team, as is likely to have been the case for a firm in an Anglo-Saxon corporate governance system, the threat of a voting battle or hostile takeover might, for example, be that costly punishment. However, Consilium, like most Swedish and continental European publicly traded corporations, has a controlling shareholder (Agnblad *et al.*, 2001; La Porta *et al.*, 1999); and Consilium's controlling shareholder, the Rosenblad family, is a majority owner that is able to outvote other shareholders should a voting contest be necessary. This majority position, of course, also leaves the Rosenblad family more dependent on Consilium's performance for personal wealth, a strong incentive to see the firm perform well.

Yet, monitoring is still relevant. In corporate governance systems where controlling shareholders dominate firms, the central conflict is typically not between the shareholders and management (which is monitored by the controlling shareholder). Rather, it is between controlling shareholders and minority shareholders, because the former have both the incentives and often the ability to expropriate the latter (Nenova, 2003), e.g. by nepotism, empire-building, depressing share price to acquire the firm cheaply, and so on. It was this risk of expropriation by the controlling shareholder that became the key focus of monitoring for the outside shareholders at Consilium, and the one risk from which they sought protection.

The potential punishment in the outside shareholders' hands was their collective holding of a corner position (10% of the stock), which in Swedish company law gives access to such formal minority protection devices as the ability to block an acquisition, to appoint a minority auditor, or force forward dividends. Forming a long-term coalition, while costly and susceptible to free riding (Jansson, 2007), thus became an important element of the shareholder activists' strategy in interactions with the controlling shareholder. The following quotation illustrates the significance of this.

> A good controlling owner is a stabilizer in a corporation. A stable controlling owner that, in principle, can decide on anything at a general meeting can make these decisions – long-term decisions – that may be hard to make with many smaller owners that want quick results, so to speak … But at the same time, it is a bit intimidating with such a strong controlling owner that can do, really, anything whatsoever. This is where this corner position comes in, … to have a small guarantee that they cannot, all in all, do what they want to. But, really, we smaller shareholders in a way sit in the lap, so to speak, of a large owner. So in one way it is a bit intimidating. [Mr. Palmqvist]

To the extent that a controlling shareholder does not do anything formally illegitimate, e.g., provable tunneling of company resources, minority shareholders cannot, as in the case of Consilium, formally force any behavioral changes by means of minority protection. Minority expropriation in Sweden seems generally to be characterized more by entrenchment leading to poor decision making, which is not illegal, than by a tunneling of resources (Holmén and Högfeldt, 2004). Hence, these formal minority protection devices are rarely used; when they are used, however, they typically receive a lot of attention in the business media.

Controlling shareholders, whose wealth depends significantly on the performance of the firms they control, can capitalize on a reputation for acting in the interests of minority shareholders; such a reputation gives the firm access to less costly financing (Gomes, 2000). Media-captured public displays of minority dissatisfaction can compel insiders to change their ways to better accommodate the interests of outside shareholders (Johnson *et al.*, 2005); failure to do so can be harmful because it can negatively affect reputation (Jansson, 2013). As the head of Consilium's controlling family put it,

> One could say that the institutional investors have responsibility towards their shareholders, to enlarge the capital. It is their responsibility. How they, then, enlarge the capital, as long as it is legal, the investors probably do not give a damn. The private investor does not have responsibility for anyone but himself. As for the responsibility towards the employees, the society, the long-term view and so on, it is self-evident that the founder or controlling owner has to carry that. … If you are not perceived as taking that type of responsibility, then you are

> dead in the long run. Who will then invest in you and who will believe in you and so on? One must be perceived as a responsible owner! [Mr. C. Rosenblad]

Access to minority protection and, as a consequence, media channels gave Consilium's shareholder activists the option to intervene should their monitoring detect expropriation, since they had the capacity to inflict harm on the controlling shareholder. To that extent, their safeguarding against risks of expropriation could be functional, even though they could not instigate and win a voting battle or otherwise seize control. They could, in the capacity of shareholder activists, 'be' a governance mechanism consisting of two elements: monitoring and the option to intervene reactively.

Publicity seeking, the avenue for intervention available to the shareholder activists, was not used more than once, which can be seen as an indication that the control mechanism was working properly. When the two largest minority shareholders began cooperating, they announced publicly that they were doing so. This signaled to the controlling shareholder that media attention could be attracted if necessary. Combined with the fact that the controlling shareholder knew he was being monitored, this created disincentives to engage in expropriation; no flagrant examples of minority expropriation could therefore be detected in the material. Indeed, the activists did not expect such measures, although they did exemplify their fears such as, for example, that the focusing of the corporate structure could be stopped or reversed (i.e. empire building) or that share price could deliberately be adversely affected and the company cheaply acquired and delisted, which they thought their corner position provided good protection from. For their part, the shareholder activists were not eager to use the media, however; they did not want to disturb their relationship with corporate insiders, through whom they received soft information by discussing the interpretation of public data. For minor conflicts of interest, exerting undue pressure on the controlling shareholder was simply not worthwhile, since it would have impaired future monitoring capacity.

Monitoring effectiveness was strengthened by the activists' accumulation of specialized human capital. This enhanced human capital likely made them more competent as monitors; at least this seemed to be the signal that insiders received. The controlling shareholder recalled the minority shareholders as "tremendously knowledgeable" and asking penetrating questions; this likely increased the perception that they would detect any self-enriching behavior. At the same time, the controlling shareholder also, to some extent, made use of this specialized human capital; an increased tendency to discuss strategic matters with the outside shareholder group was reported.

> Of course, we have not been given this [present] position instantly, so to speak. It has been stair climbing. Initially, well, they were keen on showing [us] that they had read the letter and that they had listened to us, but it did not really have any effect on what they did, but it was more like we moved our position forward subsequently, in particular when [the second largest minority shareholder] entered the picture and we got our corner [position]. Then there was a noticeable change in attitude [by insiders], it really was. But if it was specifically because we got this corner position or if it was because we had built up a relationship during this time, which is constantly developed, [I cannot tell]. Probably both. Chicken and the egg, so to speak, but probably a combination of both. [Mr. Palmqvist]

DISCUSSION AND CONCLUSIONS

Despite numerous studies, the issue of what motivates shareholder activism remains unresolved (Karpoff, 2001). In the standard explanation of shareholder activism, the motivation is to discipline inefficient management or other insiders and thereby bring about improved stock performance, which the activist is able to partially capture (e.g., Cohn and Rajan, 2013; Alchian and Demsetz, 1972; Admati *et al.*, 1994; Kahn and Winton, 1998; Maug, 1998). This paper contributes to the literature on shareholder activism by identifying and outlining an alternative type of shareholder activism: defensive shareholder activism, which is motivated by increased costs for exiting an investment.

The general mechanism of defensive shareholder activism is well documented in transaction cost economics (e.g., Williamson, 1985, 1996). The idea that an increase in the asset specificity characterizing a transaction creates incentives for setting up a costly safeguard to limit hazards of opportunism is well established within this tradition. When specificity of an investment in stock rises, which in the case study resulted from falling liquidity of the stock and the shareholder activists' investment in specialized human capital (a certainly not exhaustive list of potential sources of specificity), it may become worthwhile for minority shareholders to allocate resources towards safeguarding it against expropriation. By becoming a shareholder activist, the shareholder becomes that very safeguard. Such shareholder activism could be regarded as the middle ground between remaining at arms-length distance to the company and becoming an insider, e.g., by accepting a board position, which, in Williamson's (1985) terminology, would represent unified governance, prompted only by high degrees of asset specificity.

The Consilium case study illustrates the characteristics of this type of shareholder activism: intensified monitoring backed by an option to intervene should expropriation be detected. If competence in monitoring and the capacity to intervene is credibly signaled to insiders, disincentives for expropriation are created, and shareholder activists may never have to engage in conflict with corporate insiders. Increased asset specificity increases the incentives for the activists to maintain decent access to efficient monitoring technologies. 'Friendly' relationships with corporate insiders are, under these circumstances, a valuable asset since they enhance access to soft information (Black and Coffee, 1994), thereby increasing monitoring capability. Investment in human capital specializing in the monitored firm improves monitoring capacity and thus becomes attractive for the defensive shareholder activist. The result, however, is further specific investments supporting the investment in the target firm, making it even more costly to exit, since this capital will be of less value for monitoring other firms. In this sense, defensive shareholder activists face a situation similar to that of financial analysts (Coffee, 2006). Intervention has potential costs, notably reduced access to soft information, making it attractive only when expropriation is of some significance. This additionally makes interventions of a more aggressive kind, as in offensive shareholder activism, less attractive. On the other hand, for the safeguarding to be effective, insiders must be persuaded that the shareholders will use this option should the need arise.

Caution, of course, should be exercised in any attempt to generalize from a single case. The degree to which the Consilium case study is representative of shareholder activism as a response to increasing exit costs, and the prevalence of such shareholder activism, is a question for future research. Certain contextual characteristics of the environment in which the case study is embedded have obvious consequences for how the chain of events plays out. Swedish publicly traded firms are generally characterized by dominant controlling shareholders and, at least in formal regulation, weakly protected minorities (Agnblad *et al.*, 2001; Jonnergård and Kärreman, 2004; Jonnergård and Larsson, 2007; La Porta *et al.*, 1999). Therefore, diverging interests between controlling shareholders and minorities are more likely to instigate shareholder activism than diverging interests between shareholders and management. Shareholder activism is also likely to consist more often of interactions between controlling shareholders and minority shareholders.

The Consilium case study is characterized mainly by interactions between minority shareholders and a dominant controlling shareholder. This, plus the provisions of Swedish minority protection, influenced the strategies chosen by minority shareholders to achieve their goals. Their decision to form a coalition collectively holding enough stock to access formal minority protection was fitting given the dominant position of the targeted firm's controlling shareholder, an ownership structure commonly found in Swedish publicly traded corporations. This type of collective position poses a credible threat to a controlling shareholder's reputation because it gives the activists greater access to media channels they can use to generate publicity in response to attempts at expropriation. Alternatively, should corporate insiders not have significant ownership of stock, the threat of a voting contest might be an equally powerful deterrent.

In other words, the strategies that defensive shareholder activists use to reach their safeguarding goals may be context dependent. However, this does not change the basic logic: When exit costs rise significantly, incentives are created to set up a safeguard in the form of intensified monitoring with reactive interventions to address significant expropriation efforts; the means by which the monitoring and interventions occur are, however, likely to vary across contexts. Thus, the basic mechanism of defensive shareholder activism is likely to be of a more universal character (cf. Williamson, 1996).

The identification of defensive shareholder activism has implications for the debate about the link between liquidity of a firm's stock and the willingness of the shareholders to exert control over the firm. Interestingly, it has been argued both that less liquidity results in greater shareholder oversight (Edmans *et al.*, 2013; Coffee, 1991; Bhide, 1993; Helwege *et al.*, 2012) and that more liquidity results in greater shareholder activism (Kahn and Winton, 1998; Maug, 1998). When a distinction between the standard explanation of shareholder activism (offensive shareholder activism) and defensive shareholder activism is made, it becomes clear that these positions are not contradictory. More liquidity increases the incentives for offensive shareholder activism since it yields opportunity for profitable trading around activism. Less liquidity makes it more costly for a large shareholder to exit, creating incentives for defensive shareholder activism to safeguard against expropriation of the investment, which is costly to terminate.

Defensive shareholder activism differs from the standard explanation not only in its motivation, but also in its consequences for the firm. While the standard explanation describes an offensive seizure of a profit opportunity by means of accomplishing some change in the firm, defensive activism implies reactive safeguarding against threats that cannot be escaped without cost. Offensive shareholder activism has a clear link to stock price (Alchian and Demsetz, 1972). A shareholder devoting resources towards realizing changes to increase a firm's performance should typically be rewarded by increased firm value unless the chance of succeeding in realizing the value-increasing changes is zero.

Defensive shareholder activism is not aimed at accomplishing specific changes directed at increasing firm value, but at monitoring more generally and potentially intervening in response to what is detected while monitoring. The very existence of shareholder monitoring with incentives to intervene if necessary is often enough to discourage any increases in the expropriation of outside shareholders by insiders (Brown, 1998). However, the link between defensive shareholder activism and changes in stock performance is less straightforward than that between offensive shareholder activism and stock performance. It is only those shareholders that face significant degrees of specificity that have incentives for devoting resources towards safeguarding. Other shareholders, those who have virtually costless access to the exit mechanism for escaping expropriation (signaled by falling stock price if nothing else), will not have these incentives. Consequently, they are unlikely to pay a premium simply because monitoring is taking place.

This conjecture about the weak relationship between defensive activism and stock price has implications for empirical research on shareholder activism. Abnormal returns are neither always expected nor a suitable yardstick for evaluating the efficiency of shareholder activism in all cases. Evaluating the efficiency of shareholder activism by means of abnormal returns makes sense only to the extent that the activism indeed is of the offensive type. Hence, empirical research on shareholder activism might consider including variables controlling for the level of specificity faced by shareholder activists. However, shareholder activists are expected to have similar characteristics, regardless of the type of activism in which they are engaged. The larger the position in relation to total stock and in relation to portfolio, the stronger the incentives for shareholder activism of either type (cf. Coffee, 1991; Gillian and Starks, 2000). This makes the empirical differentiation between these two types of shareholder activism problematic.

Another difficulty facing empirical shareholder activism research is that many shareholder activists are institutional investors. A limitation to the framework presented in this paper is that the potential for agency problems in these institutions is not integrated. Money managers are not the ultimate owners of the capital they manage, and their incentives may differ substantially from those of the shareholders (Coffee, 1991; Black, 1992). It has been suggested, for instance, that money managers may be more interested in gaining visibility to further their careers (Nordén and Strand, 2011; David *et al.*, 2007; Coffee, 1991; Black, 1992) than in attempting to maximize returns to their shareholders. As long as they get positive attention, money managers may disregard that managements often tend to make only symbolic reforms to settle shareholder activism issues (David *et al.*, 2007). What this paper suggests is that the absence of positive abnormal returns around shareholder activism should not necessarily be interpreted to suggest that the activist fund managers are enriching themselves at the expense of their funds' shareholders; they may be engaged in shareholder activism of the defensive type. Discriminating between activism motivated by fund managers' desire to further their self-interest at the expense of their clients and activism in the interest of the shareholders of the funds may, however, prove an even more difficult task than discriminating between offensive and defensive shareholder activism.

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