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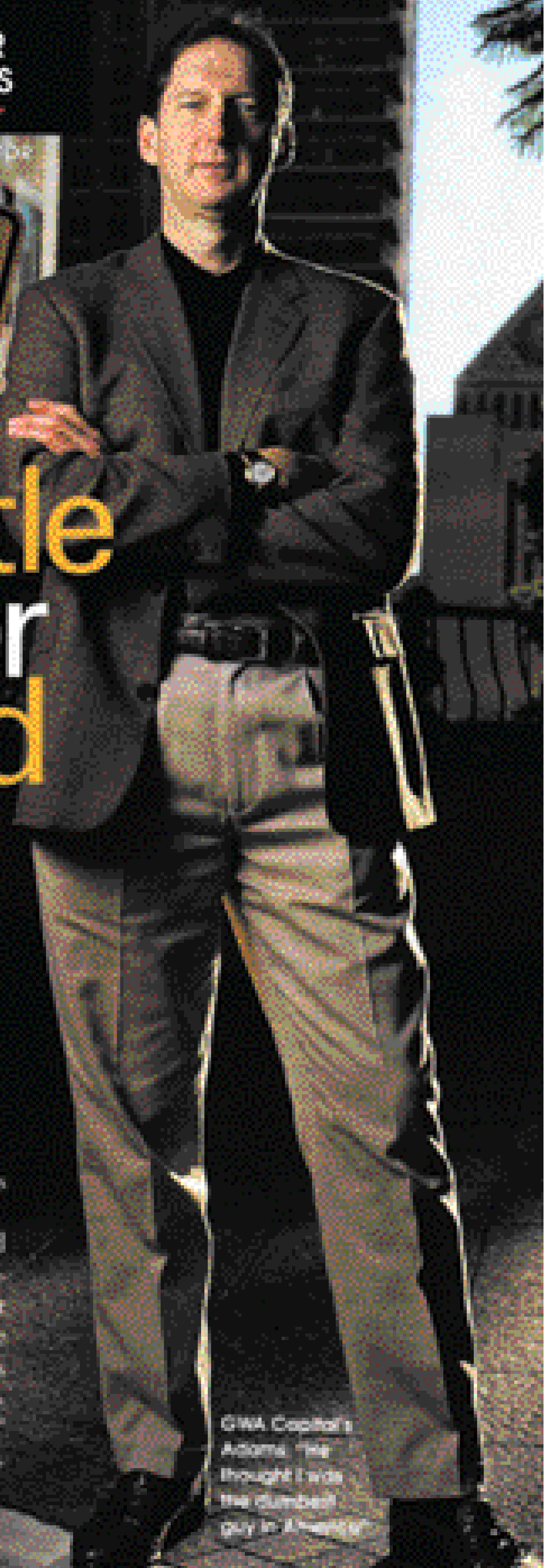
The little shareholder that could

With no industry experience, just 1,100 shares and lots of chutzpah, Guy Adams ousted the CEO of Lone Star Steakhouse from his own board. Now this new-style shareholder activist is looking for fresh targets, and he's not alone. • By Justin Schack

Guy Adams had a hard time convincing folks that he was serious.

On February 23, 2001, the onetime oil driller filed documents with the Securities and Exchange Commission announcing his dissident candidacy to replace Lone Star Steakhouse & Saloon chairman and CEO Jamie Coulter on the company's board. That afternoon a reporter from Dow Jones Newswires called. "Is this a joke?" he asked Adams. "You've only got 1,100 shares. Do you really think you have a chance?" Says Adams of the conversation, "He hung up the phone thinking I was the dumbest guy in America."

Five months later no one doubted Adams, of his resolve.



GWA Capital's Adams: "He thought I was the dumbest guy in America"

By then the lanky Louisianan had won the support of major shareholders like the California Public Employees' Retirement System and Amalgamated Bank of New York as well as that of the influential proxy-advisory firms Institutional Shareholder Services and Proxy Monitor. All agreed that Lone Star's management-dominated board needed a fresh face to reverse years of indifference to shareholder concerns.

When the votes were tallied in July, this shareholder Don Quixote had unseated the CEO from the board. It was an ugly fight - Lone Star sicced an army of litigators and private investigators on Adams, leaving him saddled with a $400,000 legal bill - and a bittersweet victory. Coulter's longtime allies on the Lone Star board received Adams coolly, excluding him from any committees.

"Board meetings have been stormy," says Adams, who turns 51 this month. "I feel totally isolated."

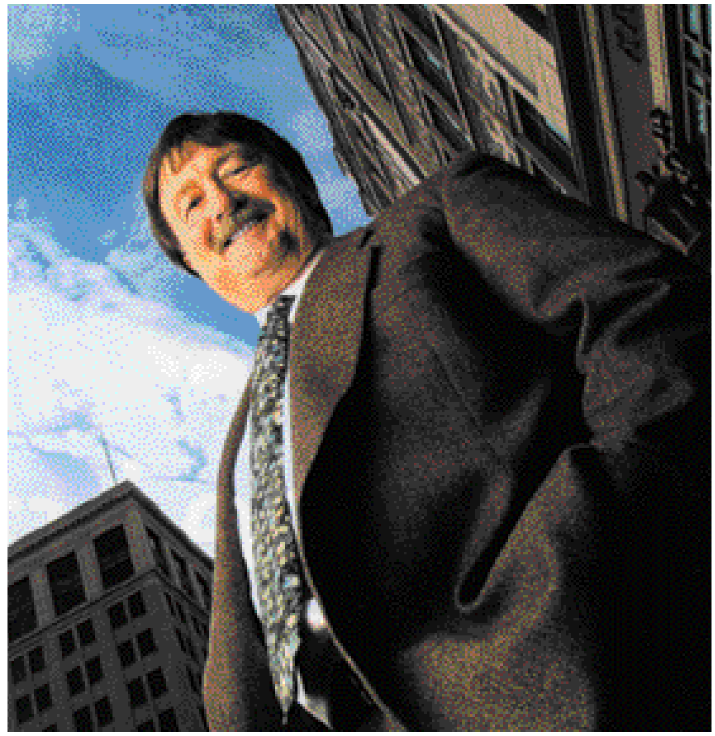
But the company has overhauled its corporate governance practices, and its share price has more than doubled since Adams began his quest, though company officials pointedly refuse to give the rebel director any credit. "We listened to the concerns as we talked to the shareholders during the proxy contest, and since then, without Mr. Adams's input or initiative, we've done quite a few things to address those issues," says John White, Lone Star's treasurer and chairman of the board's executive committee. CEO Coulter declined to comment for this story. On April 2 Lone Star announced that it had agreed to be bought by an unnamed private equity firm for $20.50 per share, or $547 million.

Adams asserts that he took on Lone Star as a test case for an activist, $50 million hedge fund he is now raising through GWA Capital, his money management firm. The aim: to invest in poorly governed companies with depressed stock prices and agitate for change. In retrospect, he couldn't have picked a better target than Lone Star. A highflier for the first few years after its March 1992 initial public offering, the restaurant chain's stock had fallen from 46 in 1996 to the single digits by the end of 1998 and was mired at about 8 last summer. During the decline, Coulter and his supporters, on Lone Star's board rubbed salt in investors' wounds with a series of self-serving actions.

"The stuff that Lone Star did was just over the top," says Ted White, director of corporate governance for CalPERS. "Bottom line, they had one of the most abominable track records I've ever seen when it comes to corporate governance."

Lone Star may have been an extreme case, but it is far from an isolated one. Even before the spectacular collapses of Enron Corp. and Global Crossing turned corporate governance into a hot policy issue, top managers and directors of publicly traded companies were finding themselves under increasing scrutiny. Traditionally loath to interfere with how companies are run, big money management firms have begun to shed their inhibitions. A grueling, two-year bear market is probably the biggest factor: What companies could get away with when most stocks were rising is no longer acceptable when they are plunging.

These changes are giving rise to a new burst of shareholder activism. In past years such activism was confined to the efforts of a handful of corporate gadflies and well-meaning social investors. There were also the greedy and the power-hungry: In the 1980s corporate raiders amassed blocks of shares of underperforming companies- and either launched tender offers for the remainder or were bought off with greenmail. The new activists are rallying the ranks of institutions like CalPERS, which for years has been nudging wayward companies to change. For more than a decade, the giant California fund has published an annual focus list of the ten worst-run companies in the U.S.


Lone Star treasurer White: "I resent it. Certainly, I wish someone else had been part of his business plan."

Joining Adams on the front lines are the likes of Texas investor Sam Wyly, who last year took on software developer Computer Associates International, and Herbert Denton, whose New York-based Providence Capital is campaigning against poison-pill takeover defenses (see box). This year's most notorious proxy fight was also led by a disgruntled shareholder: Walter Hewlett, who sought to defeat the planned merger of Hewlett-Packard Co. and Compaq Computer Corp. H-P management claimed a narrow victory last month.

All of these activists used a similar tactic: attempting to rally major institutional shareholders to back their efforts. Wyly set out to replace four directors of CA. He lost the vote but forced significant concessions from management that boosted the stock price. Last month Wyly's Ranger Capital Group hired Russell Glass, president of noted raider Carl Icahn's Icahn Associates Corp., to oversee a new hedge fund that will lobby for change at badly managed companies.

"Ranger Governance [an affiliate of Ranger Capital] has helped put corporate America, incumbent boards and top managers of public companies on notice that board-level complacency accompanied by poor performance will no longer be tolerated," says Wyly. "We believe that the large institutional investors should more aggressively exercise their power."

As this year's proxy season unfolds, former investment banker Denton has launched a campaign to strip antitakeover defenses installed by thousands of U.S. companies. His unique approach focuses on getting investors to amend corporate bylaws so that directors who vote to ignore shareholder resolutions to abolish poison pills are no longer eligible to serve on the board. Providence can claim two victories so far: The boards of Warrenville, Illinois-based truck maker Navistar International Corp. and Great Lakes Chemical Corp., in Indianapolis, have rescinded their companies' poison pills. This year Denton is targeting such large-cap bastions as Aetna, Payless ShoeSource and Toys 'R' Us. Denton is also raising a $350 million activist investment fund.

Adams, Wyly and Denton are not alone. The bankruptcies of Enron and Global Crossing, amid questionable actions by management and directors, have only served to broaden the movement. Vanguard Group founder John Bogle proposed in February that mutual fund firms form a new entity to push for better governance. Famed investor Mario Gabelli has begun using activist tactics with some of his positions - he sponsored the anti-poison pill resolution that Navistar shareholders approved and the company failed to adopt last spring, leading to Denton's attack. Shareholders have sued to kill the merger of AT&T Broadband with rival Comcast Corp., alleging that elements of the new company's governance - particularly a provision that calls for the current board of directors to serve unchallenged until 2005 - are illegal. (The company denies the allegation, and a court decision on the matter is expected this month.) Deutsche Bank has added corporate governance research, done by three analysts, to the lineup of company, sector and macro research it distributes to big investors.

"Five years ago institutions never would have voted with me," says Adams. "But they have warmed to the idea that it's okay to stand up for good, solid corporate governance. Institutions are willing to take action if someone presents them with the opportunity."

GUY ADAMS IS USED TO OVERCOMING LONG ODDS. The youngest of four children in a middle-class family in Baton Rouge, Louisiana, Adams stood 6-foot-2 by the time he reached fifth grade. When high school rolled around, coaches recruited him for the basketball team. He was not exactly a natural. "I couldn't make a layup for two years," drawls Adams. "But they kept me on the team because I was this tall, gangly kid." By his senior year, after three summers of basketball camp, Adams had become an all-district starting forward.

In 1975, with a degree in petroleum engineering from Louisiana State University, he traveled to the South China Sea as a drilling engineer for Sonat Offshore Drilling. In 1982, at 31, he enrolled in Harvard Business School.

After Harvard, Adams made his way to California, where he spent several years managing the finances of wealthy families, including the Los Angeles-based Forman family, which had amassed a fortune in the movie theater business. But he grew tired of managing so many holdings. "When you've got 45 positions, you really don't get each one in the palm of your hand," says Adams. "I want to know everything about the company and then try to influence it to do the right thing."

In 1996 Adams went out on his own, managing his money as well as that of a small-group of high-net-worth clients he had cultivated in Southern California. Several years later, on the lookout for undervalued stocks, Adams came across Wichita, Kansas-based Lone Star on CalPERS's focus list of poorly managed companies.

Lone Star intrigued Adams. Chairman and CEO Coulter, a former Pizza Hut executive, had acquired the company in 1991, taken it public and gone on an expansion spree, opening more than 200 new restaurants throughout the southern and central U.S. But the company appeared to have grown too fast. As same-store sales and profit margins began to peter out in the late '90s, the stock flagged, but Lone Star still boasted solid cash flow and almost no debt. With the right management, Adams thought, it could return to its former glory. He noted that two thirds of Lone Star's shares were concentrated in the hands of a relatively small group of 110 institutional investors.

Those investors had become increasingly agitated by what they viewed as inappropriate practices that enriched and entrenched management while the stock price tanked. Between 1997 and 2000 the board repriced options for more than 8.2 million Lone Star shares owned by Coulter and other directors - from as high as $40.38 down to $18.25 - and tripled the compensation of top management. It authorized the $10.5 million purchase of Coulter Enterprises, which, CalPERS charges in a lawsuit pending against Lone Star, was a shell company owned by Coulter. Worse, when 70 percent of shareholders voted in 2000 to do away with a staggered board - a tactic companies use to protect themselves against outsiders who would effect change by nominating rival director slates - the company and the board simply ignored the vote.

Has a board the right to legally ignore a shareholder vote? "The shareholders ought to have the power to require the board to follow their instructions, but the legal structure is the opposite," says Lawrence Cunningham, a professor of law and business at Boston College and a specialist in corporate governance. "Once elected, the board can do as it sees fit. The major power the shareholders have is to elect those guys or sell."

In 1999 CalPERS began quietly agitating for change, suggesting in writing that the company improve its governance by, among other things, appointing two independent directors. In a letter Lone Star responded that it was willing to consider steps like reviewing director compensation and forming a nominating committee. But CalPERS' Ted White didn't think that went far enough and called the company, asking to discuss the matter further.

"Their outside counsel called me later that day, saying, 'The company really doesn't want to have any conversations about this anymore,'" recalls the CalPERS governance czar. "It was very telling. It all reinforced the perception that this board was under the control of Coulter."

Lone Star treasurer John White says he and Coulter met

Ranger's Wyly: "Poor performance will no longer be tolerated."

with CalPERS officials, at their request, in Sacramento in late 1999. "We reported back to the board what their concerns were," he recalls. "Some of them we agreed with, some we didn't particularly agree with. We informed them that we were going to take several of them under advisement."

As this tussle went on behind the scenes, Adams bought 1,000 shares of Lone Star in February 2000. At the annual meeting that June, he asked management a number of polite yet pointed questions. Did Coulter need the various takeover defenses Lone Star had in place? Would the board allow shareholders to vote on selling the company if a suitor offered a significant premium? Coulter, says Adams, replied in an equally polite fashion: "The shareholders elected the board, and the board would make that decision." Adams sold his shares for a small profit and continued to monitor the company.

By November Lone Star shares had fallen below 8, and Adams set the wheels in motion for his proxy contest. He initially wanted to get a group of investors to fund a partnership - that he would control - to purchase Lone Star shares and pursue the proxy battle. Adams met with Ted White, who said that CalPERS was intrigued by the prospect of a dissident board slate but stopped short of backing him outright. Adams knew he would have to go it alone. In February he bought 1,100 shares for about $9,500 - and prepared for war.

On paper a proxy fight seemed doable. Lone Star was an extremely undervalued company with strong cash flow, little debt and a good brand name; its ownership was concentrated in the hands of a fairly small group of disgruntled shareholders. But Adams quickly realized that because of Lone Star's tiered directorships, the only board member up for reelection in 2001 was Coulter, the company's chairman and CEO, who also happened to own 19 percent of Lone Star's shares. An additional 7 percent was controlled by other managers, giving Coulter 26 percent of all shares before the contest even started.

Moreover, Coulter - for all his shortcomings in the eyes of unhappy shareholders - was a recognized name in the restaurant industry. Adams was an unknown, small-time money manager who owned less than 0.005 percent of the company. "The odds were incredibly long," says Patrick McGurn, director of corporate programs at Institutional Shareholder Services. "Typically in these situations, the first thing out of a shareholder's mouth is, 'Put me on the board because I own 5 or 10 percent of the stock.' He couldn't meet the test that says, 'My skin in the game entitles me to representation.'"

Worse, while Lone Star could marshal a team of attorneys and advisers - not to mention millions of dollars - on its behalf, Adams was working on a shoestring. But he sensed that management and Lone Star shareholders had reached a major impasse, so he forged ahead, sending the company a copy of a letter he intended to distribute to shareholders, laying out the case for his candidacy. Lone Star responded with hardball tactics. On April 20 it filed a federal lawsuit against Adams. The suit charged Adams with being little more than a dupe for other interests who wanted Coulter removed from the board.

With court approval, Lone Star subpoenaed Adams's bank and brokerage records, utility bills and the settlement of his 1999 divorce. The company alleged as a result of this discovery process that Adams could not possibly have the resources to fund a proxy battle. It issued press releases calling Adams "insolvent" and took out full-page newspaper ads suggesting that he was acting "at the behest of activists with unknown political agendas."

The strategy backfired. Though the company never specified exactly whom it thought was backing Adams's campaign, some institutions inferred that Lone Star regarded them as the real force behind the fight. Indeed, the company deposed CalPERS in conjunction with the suit against Adams.

"Their assumption that we or some other institution was secretly funneling Guy Adams money - when you think about our nature as a public institution, that's ludicrous," fumes CalPERS' Ted White. "What they were really trying to do with the suit was just spend Adams out of the race, bury him in legal bills. It really sent a message to shareholders, and the message was 'We think you're the problem not us.' That sealed their fate."

Says ISS' McGurn, "If you wanted to have a primer on how not to run a proxy fight, you could go to school on what Lone Star did in this case." But to this day Lone Star remains convinced that it was fighting organized opposition. Says treasurer John White, "We weren't able to determine that to the court's satisfaction. But it didn't make sense otherwise to us."

Adams found himself working seven days a week, camping out in his downtown Los Angeles office, rallying shareholders. His diligence paid off. Amalgamated Bank and Greenlight Capital, two of Lone Star's largest shareholders, were among Adams' earliest victories, committing approximately 1 million votes of the 26.6 million shares outstanding. On June 27 ISS announced its support for Adams's candidacy; one day later Proxy Monitor followed suit. Together the firms advise nearly 1,000 institutional investors on how to vote in proxy contests. Then CalPERS committed its 300,000 votes, and Adams knew he had the election won. "Everyone knew well before the actual shareholders' meeting that it was over," he says. At that July 6 meeting, Adams won 56 percent of the votes cast. Considering the 26 percent that Coulter already had locked in, the company's CEO was humiliated.

"But one thing is for sure: The next time Guy Adams decides to take on a big company, he won't have any trouble being taken seriously."

"I guess you could call it David slaying Goliath," says McGurn. "But at the end of the day, it was probably more that the Lone Star board was akin to the picture of Dorian Gray – it just got uglier and uglier over time in terms of governance."

NOW A DIRECTOR, ADAMS IS CONFRONTED WITH the old political dilemma: It's far easier to campaign than it is to govern. Nine months on, Adams finds himself isolated on Lone Star's board, surrounded by Coulter's cronies. He describes his relationship with Coulter, who remains CEO, and the rest of the board as "polite but tense at times." Treasurer John White acknowledges that Adams has not been given any committee assignments, because, White says, Adams has refused to sign a confidentiality agreement (although he has promised to abide by it).

His new colleagues have other reasons to hold a grudge: In October CalPERS sued Coulter, seeking to nullify the repricing of 13.6 million options from 1997 to 2000 and to undo Lone Star's $10.5 million acquisition of Coulter Enterprises. And Adams is trying to persuade his fellow directors to reimburse him for the $400,000 in legal bills he ran up with a Los Angeles law firm during the proxy fight. "He based his whole campaign on just being a lone ranger out there with a limited budget and said that his attorneys were doing it pro bono," John White ripostes. "If that's the case, we see no need to reimburse him. He said he was willing to spend his money to get elected and that it was an investment to him. He told us that this was kind of a business plan. He plans on making a name for himself as a dissident director and doing this with other companies and building a business on it. So that was his investment, the way we looked at it."

Meanwhile, Coulter carries on. "He has the support of the board and frequent contact with the board," says White. "He attends the meetings until we go into executive session, so he has our ear, and we have a great deal of contact with him on the direction of the company - resources he needs to accomplish the goals that we've all set out."

Nevertheless, Adams' complaints have borne fruit. Among the changes: The company rescinded its poison pill, amended its stock option plan to prohibit the repricing of options without shareholder approval, expanded the board by appointing three new independent directors – former Los Angeles Dodgers manager Tommy Lasorda, Mark Saltzgaber, an investment banker formerly with Montgomery Securities, which took Lone Star public in 1992, and conservative scholar Michael Ledeen - and hired UBS Warburg to advise the company on steps it could take to maximize shareholder value, which led to this month's announced sale. At this July's annual meeting, the board will allow shareholders to vote on a bylaw change to do away with staggered boards.

Lone Star's shares, now trading at about 20, have risen some 67 percent since Adams won election to the board and more than 130 percent since he announced his proxy fight. The 1,100 shares he bought for $9,500 early last year are now worth some $22,000. And Adams may not be done with Lone Star. With two more directors up for reelection this year, no one would be surprised to see a fresh proxy fight. "When a company's idea of better governance is adding Tommy Lasorda to the board? I mean, come on," says McGurn scornfully. "Nothing against Tommy Lasorda, but it was a peculiar choice for a troubled company."

Adams plans to apply his Lone Star strategy to other badly run companies - and to put more chips on the table. He's currently raising money for his new hedge fund and looking for other Lone Stars to pursue this current proxy season.

"I did it to illustrate the economic impact," Adams says of his fight against Lone Star. "This kind of investing is very profitable investing. There's value being destroyed or not being used efficiently. I can go to dissatisfied shareholders and say, 'Look, I can help you.'" He's quick to dispel the notion, however, that his new fund will be solely a vehicle for pursuing proxy fights, noting that the tactic is a costly, risky last resort to be used when management proves unresponsive.

"I resent it," says Lone Star's John White of Adams's fight. "Certainly, I wish someone else could have been part of his business plan, because I don't know that it's done anything productive for our company."

Lone Star's beleaguered shareholders would, undoubtedly, disagree. But one thing is for sure: The next time Guy Adams decides to take on a big company, he won't have any trouble being taken seriously.

Additional reporting by Steven Brull