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Looking for a Fight

Some small share holders are as mad as hell— and doing something about it

By Kris Maher

In a David-and-Goliath victory last July, small shareholder Guy W. Adams ran for a board seat at Lone Star Steakhouse & Saloon Inc. - and won.

The Wichita, Kan., restaurant chain bitterly opposed the move by the 50-year old Los Angeles investor, who owned only 1,100 shares. But Mr. Adams unseated Jamie B. Coulter, Lone Star's chairman and chief executive, by a decisive margin of 2.3 million shares. Mr. Coulter owned about 2.4 million Lone Star shares and had led the board since 1992.

Mr. Adams, who says he made his proxy fight partly because of Lone Star's executive-pay practices, typifies a growing trend in shareholder activism: more dissidents, outraged in part by pay at the top, are seeking board seats through actual or, more commonly, threatened proxy fights.

Mr. Adams's proxy fight stemmed, in part, from his objection to Mr. Coulter and other top Lone Star executives receiving generous raises and getting worthless stock options repriced, despite the company's years of poor operating results and declining share price. He also opposed the January 2001 board approval of golden parachutes for senior management in case of a change of control. Mr. Coulter was eligible for a payout equal to 2.99 times his annual salary and bonus, plus the right to cash out unvested options. During his proxy fight, Mr. Adams called the board's approval of such contracts "an excessive measure."

California Public Employees' Retiremlent System, a major Lone Star investor, sided with Mr. Adams and supported his candidacy. In an April 2001 letter to the board's compensation committee, the nation's largest public pension fund said the change-of-control accords "appear to be designed to unjustly enrich management at the expense of shareholders."

GUY W. ADAMS
Board Member, Lone Star Steakhouse

Mr. Coulter declined to comment for this article. He directed inquiries about his salary and current interaction with the board to Clark R. Mandigo, chairman of Lone Star's board and compensation committee. Says Mr. Mandigo: "In 2000, we simply decided that in light of [Mr. Coulter's] contributions and value to the company, it was desirable to bring [his] compensation up to a reasonable standard for the industry. It was absolutely an appropriate, well-deserved, overdue and reasonable increase."

Winning a Seat

Getting on the Lone Star board wasn't easy. Mr. Adams says Lone Star took numerous steps to hinder his candidacy. On April 20, the company sued him in federal district court in Wichita. Lone Star brought the suit, according to John D. White, a company executive vice president treasurer and board member, "to compel Mr. Adams to correct erroneous and misleading disclosures in his proxy." The company also claimed that an undisclosed outside source was funding Mr. Adams's campaign. On June 25, however, the court ruled that Lone Star had failed to prove there was an outside funding source and that Mr. Adams needed only to file several corrective statements. During discovery for the Suit, Mr. Adams says, Lone Star officials sought to uncover that supposed outside funding - by subpoenaing two years of bank statements and phone records for himself and his ex-wife. Mr. Adams is still trying to get Lone Star to pay him about $450,000 in related legal expenses. He denies any outsider bankrolled him. "It was a giant fishing expedition to harass me," he says.

Mr. White says of the company's efforts: "It was a contest, and we did what we thought was best to try to win it, but not to hinder the candidacy."

Shortly after Mr. Adams was elected to the board, Lone Star dropped its suit. Mr. White says the board has not been inclined to reimburse Mr. Adams for two reasons: "First, he based his campaign on being a 'little guy,' who was willing to invest his own money to win a seat on the board and whose legal counsel were supporting him on a 'pro bono' basis. Second, the legal fees he wants the company and its shareholders to pay for were a result of flaws in his proxy."

But Mr. Adams's difficulties didn't end once he landed in the boardroom. As he found, it can be equally hard for many activists to influence executive-pay debates even though they're on the board.

Mr. White characterizes the relationship between Mr. Adams and the board as cordial, but he admits: "He seems like he just wants to be a thorn in our side," adding, "We're guarded with the information we give him in the meetings."

Mr. Adams agrees. "The board meetings at times are somewhat tense," he says. "I do ask a lot of questions, and I challenge them on certain things.... If those actions are interpreted as 'being a thorn in our side,' then I guess I am."

Several obstacles have hampered Mr. Adams's ability to fulfill his campaign pledges, including one promise in particular: that he would try to improve the board's corporate governance and thereby bolster its independent view of executive compensation and other matters. His proposals included expanding the five-member board to seven.

On July 5, a day before the shareholder meeting where he won his seat, the board voted to create an executive committee. The panel, which can handle the board's full responsibilities, meets at least monthly, as well as prior to the regular board meetings attended by Mr. Adams.

And while Mr. Coulter no longer serves on the board, he does attend executive-committee meetings by invitation, says Mr. White, the committee's chairman. "We needed to have a more timely process between formal meetings to run the company with input from the CEO," Mr. White adds. "It's really not much different from the way we would function in the past when our CEO was the [board] chairman." He declines to say how frequently Mr. Coulter attends the meetings.

Lone Star directors also decided not to appoint Mr. Adams to any other board committees, which typically hammer out details of key proposals. Mr. White says the board made its latest committee assignments before last July's election results were finalized. He says Mr. Adams could be assigned to a panel in the future. Mr. Adams says his directorship seeks not so much to directly alter governance or compensation practices as to "put those issues under greater scrutiny." He explains: "Whenever you have such a delinkage of executive compensation with stock performance, that should be examined very closely by the board."

Some other dissident directors say their presence can eventually help change governance and compensation practices.

"I can sympathize with Guy," says Charles Elson, head of the University of Delaware business school's Center for Corporate Governance, in Newark, Del.

In 1997, Mr. Elson was elected to the board of Circon Corp., a surgical-supplies maker in Santa Barbara, Calif. Supported by hostile bidder U.S. Surgical Corp., he and another dissident displaced two incumbents – including the company's chairman and chief executive, Richard A. Auhll.

Mr. Auhll was chairman of the company's pay panel; many governance experts view such involvement as a conflict of interest. (Though Mr. Elson fought to prevent it, Mr. Auhll was reappointed to the board within months when another director resigned. And he joined the compensation committee again.)

For several months, Mr. Elson recalls, he was left out of private debates over critical board matters. "It was clear at meetings that important issues were decided" before he and his fellow dissident got there, Mr. Elson says.

Mr. Auhll disputes that important decisions were made prior to regular board meetings. "There were not pre-board meetings, and things were thoroughly discussed," he says. Especially in the hostile-takeover atmosphere at the time, he says, "the board as a whole was extremely careful to mind all the appropriate formality and make sure we were minding all the legal requirements."

Getting to Know You

Over the course of a year, Mr. Elson began to get to know some directors better and realized at least one had held doubts all along. "When others began to express the same concerns about the company's performance...I realized I was beginning to have some effect," he says.

Two other directors finally defected to Mr. Elson's side, agreeing to explore options – including being acquired. Mr. Auhll resigned in October 1998. Four weeks later, Circon agreed to be acquired by Maxxim Medical Inc., a Clearwater, Fla., maker of disposable medical products.

Dissident director Ralph Whitworth was able to build a consensus over pay issues at Apria Healthcare Group Inc. Mr. Whitworth is a principal at Relational Investors LLC, a San Diego investment firm that typically acquires stakes in troubled companies and often seeks board representation.

Just three months after he joined the Apria board in 1998, Mr. Whitworth suggested revamping the CEO's and the board's compensation to include more performance-based measures. He already had become board chairman and a compensation-committee member, so he didn't have much difficulty persuading the Costa Mesa, Calif., home health-care company to adopt his plan. "If you are coming from an economic point of view rather than a political or social point of view, ultimately if the directors are honest people with integrity and they're smart, you have a very good chance of winning them over on any particular issue," he says.

Is Mr. Adams finally starting to induce some change at Lone Star? That remains unclear, but some change is taking place. Last October, Calpers brought a shareholder suit against Mr. Coulter and several other longtime board members in Delaware Chancery Court. The suit alleged that the CEO and his "hand-picked board" had breached their fiduciary duties by engaging "in a pattern of self-dealing."

Though Mr. Adams wasn't involved in the suit, the suit did cite option repricings and executive raises that he had criticized in his proxy fight. Mr. Adams had criticized the board for more than doubling Mr. Coulter's salary to $750,000 in 2000, following the company's poor stock performance. For the three years ended Dec. 28, 1999, shares dropped 66.6%. For the five years ended the same date, Lone Star underperformed its industry peer group by 81%. Mr. Adams also complained about directors repricing 4.5 million worthless options – 90.9% of which were owned by Mr. Coulter and two other executives – the third option repricing in four years. And despite further drops in the share price, revenue and same-store sales during 2000, Mr. Coulter received a $226,642 bonus.

The Calpers suit also claimed that Mr. Coulter "enriched himself at the company's expense through a series of self-dealing transactions whereby he earned millions of dollars in fees, on top of his compensation as CEO." Lone Star has sought dismissal of the suit, which is pending.

"It's all about very, very old stuff," says Mr. White. "With the benefit of hindsight, you can make things look very different than they were."

About a month after Calpers sued, Lone Star directors announced governance changes. For instance, the board decided to add three more independent members, boosting membership to eight. "We've done a lot to address the concerns that we've heard out there," says Mr. White. Neither he nor Mr. Adams would give Mr. Adams credit for achieving his campaign pledge to increase board membership, however.

Now that Lone Star's share price is more than double what it was last year, Mr. Adams feels that shareholders today wouldn't object to giving executives the salary increases they got two years ago. Lone Star says neither Mr. Coulter nor Mr. White received raises last year. Nevertheless, Mr. Adams believes Lone Star directors could take further, steps that would demonstrate "a commitment to sound corporate governance."

As recently as two weeks ago, it was unclear whether Mr. Adams would be able to gain any allies who might wage another proxy fight anytime soon.

But now he may not need any. Last week, Lone Star announced its board signed a letter of intent to sell the company to Bruckmann, Rosser, Sherrill & Co., a New York investment firm, for $547.3 million, or $20.50 a share – a price near the top of the stock's recent trading range. Lone Star says the sale could happen in the third quarter, adding that Mr. Coulter plans to leave if the buyout is completed. Mr. Coulter declined to comment.

For his part, Mr. Adams says that he "would serve in whatever capacity the new buyer would ask of me."

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