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Darden Ouster Shows Low Tolerance For Board Miscues

By **Karlee Weinmann**

Law360, New York (October 10, 2014, 6:38 PM ET) -- Shareholders in Darden Restaurants Inc. dealt a rare complete victory to Starboard Value LP on Friday, giving the activist investor full board control — a notable end to this year's showpiece proxy fight and a powerful reminder that strategic and governance misplays can cost companies dearly.

Darden's investors wiped out all 12 of the company's sitting directors and welcomed Starboard's full slate of nominees, beating analysts' widely held expectations that the activist would take over a majority of board seats for the Florida-based owner of restaurant chains including Olive Garden and Capital Grille. The wholesale win sealed one of the most extreme proxy plays in recent years.

"It's a huge victory for Starboard and should serve as a warning to other boards to not antagonize the stockholder base and disrespect the activist like the Darden board did," said Chris Davis, who heads the investor activism group at Kleinberg Kaplan Wolff & Cohen PC.

New York-based Starboard picked up momentum in the marketplace in recent months, especially in the lead-up to Friday's vote. A campaign that started with a focus on the best strategy after a slow-going stretch morphed into a crusade against Darden's top brass, anchored by questions over their willingness to put shareholders ahead of themselves.

Tensions between Darden and investors, including Starboard, boiled over after it agreed in May to sell its Red Lobster unit in a $2.1 billion all-cash deal that didn't require shareholder approval. The plan, though legal, flew in the face of alternative strategic proposals presented by Starboard and another activist, Barington Capital Group LP, and left other shareholders in the lurch.

Shortly after Darden surprised the marketplace with its sale plans, Starboard gathered support from the holders of 57 percent of the company's shares for its request that the company hold a nonbinding investor vote on the Red Lobster sale plan. The company brushed it off and completed the deal, a move that haunted Darden through Friday's vote.

The special meeting would not have imposed any hard-line requirements on Darden, making it tougher for the board to justify its resistance and stand up for the Red Lobster sale, said Darren Novak, a senior vice president in Houlihan Lokey's activist practice whose firm advised on the Barington campaign.

"If you aren't willing to explain to shareholders why it isn't important to give them that voice, it becomes an existential problem for the board and management," he said. "The practical reality is, regardless of what side of the equation you come down on, is that shareholders now require their voice to be heard."

That's doubly true after top proxy advisory firm Institutional Shareholder Services Inc., which is relied upon to help investors fill in their proxy ballots, said it could withhold support for directors who ignore majority-supported shareholder proposals.

Darden never convened a special meeting, and its inaction fed into a damning ISS critique rooted in the Red Lobster sale. No. 2 proxy adviser Glass Lewis & Co. LLC joined ISS in recommending Darden investors back Starboard's entire slate, an unusual and unequivocal show of support that revved up the activist's campaign in a big way.

Both firms praised Starboard's slate of nominees — two of its own, plus an impressive crop of industry-savvy independent picks, among them the founder of TGI Friday's Inc. and the former CEO of Burger King, plus others with turnaround experience.

The impressive candidates complicated Darden's staunch defense strategy, said Keith Gottfried, head of Morgan Lewis & Bockius LLP's activism defense practice.

"The majority of them are outsiders and people who investors are able to have a high level of confidence that they're going to be truly independent directors," he said. "[Investors] looked at the outgoing board and said, 'You guys approved the sale of Red Lobster; we don't agree with that sale.' I think that was the tipping point."

In the months before Friday's vote, Darden opened itself to some changes suggested by Starboard and Barington as far back as last year. On the same late July day it closed the Red Lobster deal, the company said it would cede three board seats to Starboard — its final slate included four spots for the activist — and outlined plans to split its dual chairman and CEO role.

As part of the reshuffling, Darden said controversy-plagued CEO Clarence Otis Jr. would step down at the end of the year. The activists had torn into the executive for sluggish returns against the backdrop of criticism that his obligations to other boards prevented him from tackling Darden's problems.

Starboard roundly dismissed the concessions and vowed to keep up its fight, deflating Darden's hope for a compromise and leaving the company and its board fully exposed in the vote.

"The company had an opportunity to do any number of things much earlier on in terms of strategy or splitting up the chairman and CEO, but what they took was a much more aggressive defense, and at the end of the day, it really backfired in a spectacular way," Novak said.

Aside from exposing the risks to a company that undersells its fumbles, the Darden board overhaul helps to reinforce investors' power in the marketplace. Especially in an era where companies and activists churn out settlements at record rates, it proves activists, if provoked, can spearhead dramatic changes.

The brand of sweeping change Starboard brought to Darden can generally only upend the most troubled corporate players, but the activist's success on Friday is a warning shot for those skeptical of shareholders' power. More sophisticated investors, and more activists in general, have ramped up the pressure on companies to be proactive and open-minded.

"When you have an activist who wants to come to the table with a thoughtful plan for value creation, that's the time when you want to take those ideas very seriously," Gottfried said. "You want to, as much as possible, evaluate them and see whether or not there's really an idea there that's worth pursuing."

Darden's shake-up illustrates the cost of icing out activists altogether, in line with the just-say-no defense that took hold among companies targeted during a wave of hostile takeover plays in the 1980s. But the strategy doesn't hold up in the current marketplace, dotted with activists eager — and able — to dig into even the largest companies.

"What would work is actually understanding you've got an issue and there might be some valid options, so what can you do to actually bridge the gap between management's and the board's plan on one hand and the activists' on the other?” Novak said. "Bridging that gap is not losing all 12 directors."

--Editing by Katherine Rautenberg and Mark Lebetkin.
