How Wall Street Enabled A Controversial Power Grab At A Wannabe Berkshire Hathaway

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When Sardar Biglari, CEO of Biglari Holdings, won a hotly contested shareholder proxy in April, investors feared his next move would be to cement control over the company. They were right, and a review of Biglari's actions in recent months shows he did so with the help of leading Wall Street investment banks.

Mr. Biglari gained a name on Wall Street during the crisis for his hand in the turnaround of burger chain Steak 'n Shake, and his conversion of the NYSE-listed company into a conglomerate modeled after Warren Buffett's Berkshire Hathaway. But, in recent years his performance has soured, and boardroom moves dictated by Biglari drew shareholder ire, leading to a proxy fight in 2015. Investors accused Biglari of shuttling corporate assets into a his hedge fund without their approval to gain unwarranted voting power over of the company, while also creating large incentive payouts for overseeing investments that once belonged to them.

Biglari won the vote, arguing the company was merely a vehicle to invest in his skills and fees he charged were lower than hedge funds. But, the results were unconvincing. He was elected with affirmative votes from just under 50% of the company's outstanding shares, including a near 20% block voted by Biglari. Governance concerns raised by minnow-sized activist Groveland Capital in the fight were generally supported by proxy firms Glass Lewis and ISS, and some Biglari-appointed board members wouldn't have been re-elected without his votes.

In the face of that shareholder discontent, Biglari tipped his hand this month on how he would respond.

On June 3, Biglari Holdings changed its bylaws, setting a foundation for Biglari to gain further influence over the Indiana-incorporated company. It opted out of an Indiana state law that limits a single shareholders' voting rights to 20%, unless given approval by investors. Through controversial asset transfers prior to June, Biglari took control of nearly 18% of Biglari Holdings through his hedge fund, The Lion Fund.

A day after the bylaw amendment, The Lion Fund took control of $63 million in additional Biglari Holdings shares, and it launched a tender offer for 575,00o shares at a price of $420 apiece, potentially bringing its ownership to 47.5%, a near majority that would make it hard for outside investors to influence governance, run a proxy, even make their own tender. The deal would also anchor hedge fund-like performance fees on nearly half the company's stock. [Biglari personally owns just 1% of the company that dons his name]

Patrick Clifford, a Biglari Holdings spokesperson at Abernathy MacGregor, declined to comment when given multiple opportunities to discuss the tender and bylaw change.

Biglari's actions aside, the tender is being aided by JPMorgan Chase, which appears to be providing cash used in the offer through a derivative contract it entered into, and investment banking boutique, Houlihan Lokey, which is acting as dealer manager.

First to JPMorgan and its derivative contract with Biglari's Lion Fund, the party making what amounts to a $241 million cash tender.

Investors in Biglari Holdings once owned the Lion Fund. It was part of a 2010 deal to that led to an incentive arrangement where Biglari would be paid a salary of $900,000 and a 25% share in the company's annual book value growth above a 6% hurdle, capped at $10 million. But Biglari, apparently, was left unsatisfied. He bought back The Lion Fund in 2013 and began transferring the company's non-operating assets — an over 19% stake in Cracker Barrel Old Country Store, a large tranche of Biglari Holdings shares, and cash — into the fund to the dismay of shareholders.

In 2013, Biglari's compensation surged from $10.1 million to over $25 million, and in 2014, it rose above $30 million, as over a half billion dollars were transferred to The Lion Fund.

The moves, proxy advisory Glass Lewis said, created "a circuitous and economically misaligned ownership framework between Biglari Holdings and Mr. Biglari's shareholder-funded investment vehicle." Shareholder sued Biglari, but their case was thrown out of an Indiana court in March. Nonetheless, the arrangement is an extreme outlier for a NYSE-listed company, and it is graded an 'F' on pay-for-performance by Glass Lewis. [Biglari didn't address the grade in proxy documents]

But those issues did not stop JPMorgan from dealing with The Lion Fund.

In February, it entered what is called a pre-paid variable share forward with the fund that effectively doled out $135.1 million in cash against 1,250 million Cracker Barrel shares – nearly a quarter of the fund's holding – which were once owned unencumbered by Biglari Holdings investors. And that cash appears to be a key funding source for The Lion Fund's tender. It had just $35 million in cash at the end of 2014, filings show, despite taking in $60 million in cash through the course of the year, the bulk of it likely from an August rights offer of 340,000 Biglari Holdings shares priced at $250, a 40% discount at the time.

JPMorgan declined to comment, citing a prohibition on speaking about client transactions. The bank had no responsibility to predict the result of the forward, and conducted a normal vetting of The Lion Fund as a counterparty, said a source with knowledge of the transaction.

The governance issues also did not stop boutique investment bank Houlihan Lokey from engaging with The Lion Fund as dealer manager. Although Houlihan is not playing an advisory role, the tender offer filing states that as dealer manager the bank, "may communicate with brokers, dealers, trust companies and similar entities with respect to the Offer. Houlihan Lokey Capital, Inc. will receive, for these services, a reasonable and customary fee."

Houlihan Lokey declined to comment, citing a policy against speaking about client engagements.

A board committee at Biglari Holdings met last week to make a recommendation to investors on the tender, taking into consideration potential conflicts of interest from Mr. Biglari's control of related parties such as The Lion Fund, and the impact of a further consolidation of his control. The committee worked with company counsel, Latham & Watkins, and outside counsel, Kreig DeVault. However, a filing disclosed late on Friday shows, that it decided to make no recommendation to shareholders.

"Based upon the potential for a conflict of interest resulting from the Company's ownership of limited partnership interests in the Purchaser, the Independent Directors unanimously voted to recommend that the Board express no opinion and remain neutral with respect to the Offer," the company said.

"In view of the variety of factors and the amount of information considered, the Independent Directors did not find it practicable to, and did not attempt to, provide specific assessments of, quantify, rank or otherwise assign relative weight to the specific factors considered in determining to express no opinion and remain neutral with respect to the Offer," the company added, of its due diligence.

It's now up to investors to decide if they tender shares, with dealer manager Houlihan Lokey as their primary contact. Okapi Partners, information agent on the tender, also declined to comment.

Leading corporate governance experts decry the deal, in addition to Mr. Biglari's actions as chairman.

"The tender offer is an aggressive entrenchment move aimed at enabling the CEO to use the shareholders' money to gain control over the company," says Lucian Bebchuck, director of the program on corporate governance at Harvard Law School. "Given that the CEO's management and performance has been controversial, it is especially important for this company's shareholders to retain the power to vote for a change of control. Unfortunately, if the tender offer is successful, the CEO would become fully entrenched," he adds. However, at a price of $420, some investors may be enticed.

Biglari Holdings shares plummeted nearly 20% to just over $350 in the month after Biglari won the proxy fight; evidence of investor discontent and the company's continued operational issues in the first quarter. Investors are also faced with the prospect of owning shares in a company controlled by a shareholder unfriendly CEO. "Although shareholders are seemingly free to decide whether to tender their shares, shareholders may be forced into tendering by the fear of remaining with low-value minority shares with little say in the event they do not accept the offer," Bebchuk says.

Nonetheless, there is also reason to hold out. The tender amounts to a take-under from year ago levels, or the price the stock reached in late 2010, for that matter. It also gives virtually no worth to Biglari Holdings' operating businesses like Steak n' Shake.

Presently, shareholder interests in Cracker Barrel are valued at nearly $700 million. At Biglari Holdings' current market capitalization of $840 million, little worth is being given to Steak n'

Shake's nationwide restaurant business, which earned nearly $800 million in revenue in 2014, or its other operations.

Mario Gabelli, CEO of GAMCO Investors, the company's largest outside shareholder, voted against re-electing Biglari's board in April. However, he appears to be toying with the notion that a renewed power grab may plant the seeds for change.

When reached by telephone, Gabelli told *Forbes*, "if you buy stock and stick it into an entity which you have control over and are going to vote in favor of yourself, it has to be examined." But, he was more interested in discussing hypothetical of change, for instance the testing the validity of Biglari's bylaw alteration, or the prospect of another challenge from shareholders.

" There are individuals that run companies that are going to be subject to microscopic scrutiny on how they expense items and a host of other things," Gabelli said. The tender, "doesn't preclude someone from saying we are concerned about all of these related party transactions. It doesn't preclude individuals from taking action on those issues," he said.

Gabelli declined to comment whether he would participate in the tender, which expires on July 1, but he pointed out holdout investors will see their economic interests in the company rise as more shares are pulled into The Lion Fund. Shareholders, after all, own a significant majority of the fund.

Because of the circularity in the structure of Biglari Holdings, how much would a competing tender from an outside investor really cost?