SHAREHOLDER RELATIONS

Farmer Bros. Board Faces Unique Threat: Loss of Indemnification

DIRECTORS OF THE SMALL FOOD SERVICE distributor Farmer Bros. could be left without indemnification and thus no protection from shareholder lawsuits or regulatory settlements. That's if the company's largest outside investor, **Franklin Mutual Advisers**, gets its way.

In what may be an unprecedented move, Franklin, one of the country's largest mutual fund firms, is sponsoring a shareholder proposal that would give shareholders the right to refuse to indemnify Farmer Bros.' directors. Under the proposal, the company wouldn't pay any expenses, judgments, fines or settlements stemming from an alleged breach of duty unless compelled to do so by a court ruling.

Franklin argues that Farmer Bros. stock is undervalued by nearly a third of its current price. It also contends that Farmer Bros. is sitting on a $300 million pool of cash and securities that is going untapped and should also be registered as a mutual fund.

The money manager filed the proposal after less drastic measures of persuasion to boost the stock's price, put the hoard of cash to work or register those assets as a fund got nowhere.

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David Winters, Chairman and CEO, Franklin Mutual Series Fund

By taking away directors' right to automatic indemnification, Franklin intends the proposal to concentrate directors' minds on improving the company's governance. "It basically, hopefully, will make the board more sensitive to the shareholders' interests," says **David Winters**, chairman and CEO of **Franklin Mutual Series Fund**. He expects the proposal to win a majority of non-management votes.

Governance experts say Franklin's move to get directors to respond is a significant event for corporate boards that bears watching. In fact, threatening to withhold indemnification may be another way to increase director accountability. "Indemnification is an innovative approach to that," says **Richard Ferlauto**, director of investment policy at the **American Federation of State, County and Municipal Employees**.

Legal experts disagree as to whether the proposal would in fact be enforceable if passed. **Paul Dawes**, a partner with **Latham & Watkins**, suggests that directors would be able to get indemnification from the company even if shareholders balk, since Farmer Bros. is incorporated in California. Dawes notes that California law establishes four methods of approving director indemnification. The indemnification can be authorized by shareholders or a court of law, but also by legal counsel or by directors themselves.

Yet others say a shareholder refusal to grant indemnification trumps everything. **Gary Lutin**, an investment banker who chairs an online forum for Farmer Bros. shareholders, says most states' laws prevent directors from determining their own indemnification rights. "So if the shareholders make the determination, you can't go get a law firm, and you can't get the directors to vote or anything," he claims.

Some observers question whether the proposal would do more harm than good if passed. For instance, observers question whether anyone would agree to sit on a board that had that stricture in place. "I sure as heck am not going to want to go on that board," asserts **Roger Raber**, president of the **National Association of Corporate Directors**.

Yet shareholder activists say it definitely hits the zeitgeist of the times. "It's part of the larger trend of holding board members responsible for their actions," says Ferlauto of AFSCME.

Franklin owns 9.6% of the company's shares. As of Dec. 31, chairman and former CEO **Roy F. Farmer** owned over 43%. Franklin says the company's board favors Roy Farmer and his branch of the founding family at the expense of other shareholders. Much of Franklin's concern has to do with the lack of disclosure emanating from Farmer Bros.

As an example, Winters points out that the company has historically not produced an annual letter to shareholders. In addition, he says, management has always been reluctant to speak with outsiders about the company. A Farmer Bros. spokesman would not comment.

"The issue of this company, ultimately, is it's a public corporation that in many respects has been run as a privately held family business,"**Bradley Takahashi**, VP of Franklin Mutual, asserts.

Another bone of contention is Farmer Bros.' huge reserve fund, which accounts for about 70% of corporate assets. Franklin Mutual wants the company to register as an investment company because it believes the details of the cash pool aren't sufficiently disclosed. The fund company hasn't taken a position as to what should be done with the money, but the cash could be used to invest in the company's business, make acquisitions or even buy back shares to take the company private. ■