

Sun CEO Faces Pressure Over IBM

Schwartz at Odds With McNealy Over Deal; Shares Tumble 23% After Takeover Talks Break Down
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Sun Microsystems Inc.'s shares Monday tumbled 23% after talks to sell itself to International Business Machines Corp. unraveled, raising new questions about the prospects for Sun and its chief executive.

Jonathan Schwartz, Sun's CEO, is under pressure to come up with an alternative for the struggling computer

maker if talks with IBM can't be revived. The Silicon Valley icon has seen slumping sales of its servers and posted losses in three of its last four quarters.

Complicating the situation, two people familiar with the situation said Mr. Schwartz had favored the IBM offer, but a board faction led by Scott McNealy -- the company's chairman and co-founder -- opposed it. Neither of the men has publicly commented on the negotiations, and, through a spokeswoman, both declined to comment Monday.

In a statement Monday, Sun said it "is committed to its leadership team, growth strategy and building value for its shareholders."

People close to Sun characterized Mr. Schwartz's status as precarious if the deal with IBM is not revived. An official at an institutional holder of Sun shares, which recently sold most of its stake, added that being on the losing side of a boardroom split -- especially with a person of Mr. McNealy's influence -- puts Mr. Schwartz in a particularly difficult position.

Analysts and investors cite what happened at Yahoo Inc. after Microsoft Corp. last year pulled an unsolicited offer that the Internet company had rejected as too low. The situation turned investors against Yahoo CEO Jerry Yang,

whom the board replaced this January.

"I wouldn't be surprised if this deal doesn't go through that it might mean that there's a change at the top of Sun," said Peter Falvey, co-founder of investment bank Revolution Partners, which he said has worked with both IBM and Sun.

Several high-tech recruiters echoed that thinking. "If Sun has no other suitors in the pipeline, this will give them a chance to wipe the slate clean and bring in new leadership," predicted Seth O. Harris, head of the technology practice at search firm Cook Associates in Boston.

Mr. Harris said Sun directors may bring back Mr. McNealy as interim CEO, but the former Sun leader -- who ran the company for 22 years -- is neither seen as the most likely person to engineer a sale nor the kind of nuts-and-bolts operations specialist that some observers think Sun needs.

Mr. Schwartz, who took over as CEO of the Santa Clara, Calif., from Mr. McNealy in 2006, has made some progress in shifting Sun's focus toward software, but the company still gets a big chunk of its revenue from a line of server systems that has faced slowing sales lately.

"Jonathan finds himself in a very tough position," said Umesh Ramakrishnan, a vice chairman of recruiter CTPartners. Wall Street had been questioning the company's long-term viability under Mr. Schwartz's strategy, Mr. Ramakrishnan said.

Though Sun has long had critics on Wall Street, some investors are now in a position to make their views felt. The private-equity firm Kohlberg Kravis Roberts & Co. received a board seat in 2007 after making a \$700 million investment in Sun. Southeastern Asset Management Co., which last year disclosed it had invested more than \$2 billion to become Sun's largest

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shareholder with 22% stake, was granted two board seats; it has only named one director so far.

Neither KKR nor Southeastern has made known their position on the IBM offer; KKR declined comment and Southeastern did not return calls.

One factor complicating a potential deal with IBM is the prospect the companies might have to wait up to a year for government antitrust reviews. As a result, limitations on IBM's ability to abandon the deal became a big factor in the talks, these people said. But pricing was also a factor; Sun's board on Saturday rejected an IBM offer and countered with a \$10-a-share price, they added. IBM withdrew its offer Sunday.

Sun's stock fell \$1.93 to \$6.56 at 4 p.m. on the Nasdaq Stock Market, but it remains well above the \$4 to \$5 level where it was trading before the talks with IBM surfaced last month.

Standard & Poor's Ratings Services Monday warned it could downgrade its credit ratings on Sun if it remains an independent company.

S&P said Sun's ratings could be lowered if the company approves such "shareholder friendly" measures as a large stock repurchase or a one-time dividend funded by debt.

The ratings also could drop because of Sun's weak operating performance, the rating agency said.