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Lessons for Boards of Directors from In Re Del Monte Foods Company Shareholder Litigation

About the Author

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The Re Del Monte Foods Company Shareholder Litigation case from Feb. 14, 2011 2011, presents a window into the pressures on bankers to generate fees, and some key lessons to target boards of directors managing M&A transactions.

The banker's failure to disclose to the Del Monte board certain activities gave rise to the issues in the case. For example:

- the banker did not disclose to the Del Monte board its behind the scenes efforts to put the Del Monte in play prior to the banker's engagement by the board,
- the banker didn't tell the board that it had a goal of providing buy-side financing,
- the banker arranged with the private equity firm with which it had the strongest relationship (also undisclosed to the board) to provide part of the buy side financing, and only after reaching that agreement did the banker seek authorization from the board; and
- the banker did not disclose that it had steered the previous high bidder in an earlier aborted sales process into a club deal with that private equity fund who had agreed to have the banker as part of the financing syndicate.

The *Del Monte* court concluded based on these facts, that there was a fraud upon the Del Monte board by the banker. One might have expected sympathy for the Del Monte board, given the deception. Instead, the court held that plaintiffs established a reasonable likelihood of success on the merits of their claim that ***director defendants*** failed to act reasonably in connection with the sales process. The Vice Chancellor explains that the directors breached their fiduciary duties to shareholders by "failing to provide the serious oversight that would have checked [the banker's] misconduct[.]" The Del Monte court explains that "[a]lthough the blame for what took place appears at this preliminary stage to lie with [the banker], ***the buck stops with the Board***. "

In some good news for the directors, the Vice Chancellor explains that the board did not face a meaningful threat of monetary liability. The court notes that Delaware General Corporation Law Section 102(b)(7) would likely result in exculpation of liability, and Delaware General Corporation Law Section 141(e) would likely provide protection for the board's reliance on qualified advisors chosen with reasonable care.

Although the Del Monte board is not likely to be subject to personal monetary liability, no target board would want to subject itself to the deal disruption, intense scrutiny and unflattering portrayal found in *Del Monte*. Moreover, the plaintiffs' counsel has been awarded $2.75 million in interim counsel fees by the Vice Chancellor. Thus, it is worth reviewing the lessons for target boards from *Del Monte.*

Ask up front about the bank's relationship with logical bidders, whether strategic or financial buyers.

Investment banks regularly visit private equity shops as well as strategic acquirors, presenting transactions for consideration. This activity generates access to buyers and builds relationships helpful to transactions. The banker told Del Monte that the banker was well-positioned to advise Del Monte because the banker knew many of the entities that might be interested buyers. What wasn't offered, or apparently asked, was whether the banker had earned significant fees from any of the logical bidders over the past few years. The private equity firm had paid the banker substantial fees over the past two years and the banker had worked with the private equity firm on six projects in the same industry. The banker also didn't advise that it had pitched Del Monte to the very funds it was planning to solicit here and had a specific indication from the private equity fund in question that it was "ready to take the next step."

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Further inquiry by the board about ongoing relevant relationships and conflicts of interest, like whether the bank had done substantial work for any of the likely bidders during the past two years, could have elicited information at the outset to cause the board to hire a different banker, or the board might have been more skeptical about the banker's advice and more involved in decisions regarding the sales process.

Avoid having the target banker provide buy-side financing without a clearly demonstrated benefit to target, and before price negotiations are completed.

The banker's interest in obtaining additional fees from the transaction through the financing of the transaction created the conflict. While the banker was supposed to be negotiating on behalf of the target to get the buyer to pay more, the banker had a financial incentive as a lender to the buyer to be sure that the buyer didn't over pay!

There was no deal-related reason for the banker to provide financing, and the target company did not benefit. Indeed, the target wound up having to pay a substantial additional bankers' fee to a separate bank to get a second fairness opinion due to the conflict. The more troubling harm was the obvious taint on the price negotiations. The conflict was so obvious that it forced the hiring of a second sell-side banker. The Del Monte board might therefore have considered the impact of that conflict on the process, and to understand what, if any, benefit was being conferred. The board could have asked whether the financing was critical to the deal getting done, and could have deferred giving permission until price negotiations were complete.

The banker's desire to provide the buy-side financing led it to structure "a small private process that maximized the likelihood that it could provide acquisition financing." Moreover, restrictions in the non-disclosure agreement that limited the buyers' right to contact debt sources without the banker's permission put the banker in the position to know about the financing needs of bidders. The buy-side financing also resulted a conflict for the banker running the go shop process. Thus, the taint of the conflict from the banker providing buy side financing infected the entire sales process, without any benefit to the stockholders.

> ***"One thing is clear from Del Monte — a target board should be directly engaged in the process, and at each stage the board should be asking questions, understanding the alternatives, and making decisions regarding the process in the best interests of stockholders, with the ultimate goal to maximize value."***

A target board might engage a separate banker to provide stapled financing, if it is deemed necessary, and decline to permit its sell side advisor to provide financing. This policy would preserve the independence of the sell-side banker and the process would not be susceptible to allegations of conflict. Alternatively, the target board could engage two sell-side advisors and permit only one of them to offer financing to buyers.

Seek to enforce anti-clubbing provisions in non-disclosure agreements; permit teaming only after consideration of the impact on deal process.

One particularly egregious action by the banker was its unauthorized, behind the scenes actions to pair up the previous high bidder with its favored bidder. The *Del Monte* court explains that "what indisputably crossed the line was the surreptitious and unauthorized pairing" of the high bidder in the prior aborted process, who had indicated that it needed to pair with another buyer, with the private equity fund for whom the banker had arranged to provide financing. An independent banker could have teamed the other bidder with a different sponsor to induce competition.

The banker concealed from the target board its role in putting the two bidders together. Nevertheless, the board did not provide oversight of the process. The minutes did not reflect a board discussion about how a pairing could affect competitive bidding or whether there were alternative pairings. Although the Del Monte board could not have known of the banker's actions to put the two bidders together, the board could have objected to the pairing, given the prior history with the high bidder in the prior failed process and the desire to have a competitive process.

Manage the go shop process to maximize the likelihood of bids.

The participation by the banker in the buy-side financing created a conflict with respect to the "go shop" process. A "go shop" process is a period following the signing of a merger agreement during which the target is permitted to contact other potential interested buyers. The conflict arises from the fact that a bank providing financing for the deal would want the deal with the initial buyer to be consummated (so that the banker could obtain the financing fees), even if there was a superior deal from another bidder. It is hard to have confidence in a process run by a banker that has a clear conflict of interest against the process yielding any new bidders. There was no evidence that Del Monte board thought about this conflict. The board also did not have insight into how the banker interacted with the potential bidders being contacted in the go shop process. The board could have dealt with these conflicts by declining the initial request from the banker to provide buy-side financing, hiring the second bank to run the go shop process, or putting itself in an active supervisory role regarding the go shop process.

Ask questions and understand the process and the advice of advisors with the goal to develop a process to maximize stockholder value.

One thing is clear from *Del Monte* — a target board should be directly engaged in the process, and at each stage the board should be asking questions, understanding the alternatives, and making decisions regarding the process in the best interests of stockholders, with the ultimate goal to maximize value. The board cannot rely on the banker to establish or manage the process without considering the choices the banker is making in light of the objective to maximize value.