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Corporate Governance Update: *Del Monte* and Responsibility of Board in a Sales Process

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The acquisition of Del Monte Foods Co. by a group of financial buyers was completed earlier this month.[1] The shareholder vote, which took place in early March, had been delayed for twenty days by the Delaware Court of Chancery because the court found that the financial advisor to Del Monte's board had failed to disclose important information to the board and had become so conflicted in the transaction that the entire process had become tainted by the financial advisor's misconduct and the directors' breach of their fiduciary duties.[2]

The Del Monte transaction highlights important considerations for companies pursuing sale transactions, whether in the context of a going-private transaction or a sale to a strategic acquiror. One set of issues centers around the board's oversight of its financial advisors, and another concerns the appropriate use of special committees by boards. The opinion of Vice Chancellor Laster in the *Del Monte* case is a powerful reminder to directors that actions such as hiring advisors and forming special committees—while appropriate and even essential in some circumstances—do not obviate the need for members of the board to be fully engaged in and actively supervising the process of negotiating a significant company transaction.

Background of the Transaction

The Del Monte board decided to explore a potential sale of the company in early 2010, and retained a financial advisor who had previously done work for the company. According to the court's opinion, which was in the context of a summary proceeding seeking preliminary injunctive relief where the plaintiffs need only show a reasonable probability of success on the merits, the board's financial advisor failed to reveal to the board it had been

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[1] *KKR, Vestar and Centerview Complete Acquisition of Del Monte Foods*, Del Monte Foods Co. Press Release, Mar. 8, 2011.

[2] *In re Del Monte Foods Co. S'holders Litig.*, C.A. No. 6027-VCL (Del. Ch. Feb. 14, 2011) available at courts.delaware.gov/opinions/download.aspx?ID=150840. The court noted that to obtain an injunction, the plaintiffs needed to establish a reasonable probability of success on the merits: "This showing 'falls well short of that which would be required to secure final relief following trial, since it explicitly requires only that the record establish a reasonable probability that this greater showing will ultimately be made.'" *Id*. at 26 (citation omitted).

attempting to stir up interest in acquiring Del Monte among financial buyers since late 2009. The court also found that the financial advisor did not inform the board that the financial advisor intended to seek to participate in the buy-side financing for any sale of Del Monte. The board followed their financial advisor's recommendation in structuring the sale process, which was a limited, non-public process primarily involving large private equity firms. The court noted that, while this approach had "sound and reasonable justifications," it was also the sort of process that would most likely result in the financial advisor being able to provide buy-side financing.[3]

The private equity participants in the sale process managed by the financial advisor executed confidentiality agreements containing customary "no teaming" provisions, which prevented the participants from discussing Del Monte's confidential information with anyone, including other private equity firms, and from discussing any potential joint bids. The "no teaming" provisions were intended to give the board the power to control and manage the sale process and allow the board to determine whether bidders would be permitted to work together, and, if so, which bidders would be allowed to team up.

According to the court's opinion, after reviewing the indications of interest that the company received as a result of the sale process, the board decided in March 2010 not to pursue a sale transaction and specifically instructed its financial advisor to terminate the process and inform the participants that the company was not for sale.[4] According to the court, unbeknownst to the board, however, the financial advisor continued to talk with some of the private equity participants about a potential transaction and even facilitated the combination of two of them, KKR and Vestar, into a potential club bid. This was in violation of the no-teaming provisions in the confidentiality agreement each party had signed and contrary to the board's explicit instructions to its financial advisor. The court noted that "[b]y pairing Vestar with KKR, Barclays put together the two highest bidders from March 2010, thereby reducing the prospect of real competition in any renewed process.... Teaming up Vestar and KKR served Barclays' interest in furthering a deal with an important client (KKR) that previously had used Barclays for buy-side financing."[5]

The court found that the board was ill-served by its financial advisor, who, when re-engaged by Del Monte to resume the sale process in October 2010, concealed the fact that the financial advisor had in the meantime arranged for Vestar and KKR to bid together. However, the court points out that the board itself was quite passive: When KKR formally asked for permission to partner with Vestar, the board did not question the advantages or disadvantages of

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[3] *Id.* at 8.

[4] *Id.* at 12.

[5] *Id at* 14.

this pairing.[6] When the board's financial advisor asked the board for permission to provide buy-side financing—before the parties had agreed on price—the board agreed, although this created a significant conflict of interest for the financial advisor and required Del Monte to pay an additional $3 million for a fairness opinion from another investment bank.[7] When that same financial advisor asked to be permitted to run the go-shop process after the agreement at $19 per share had been approved, the board agreed, despite that financial advisor's direct financial conflict of interest and the availability of other investment banks to take that role.[8]

Ultimately, the court enjoined the shareholder vote on the transaction and the enforcement of the deal protection devices (no-shop, termination fee and matching-right provisions) for twenty days, in order to give the Del Monte stockholders the opportunity to receive an untainted, pre-vote topping bid.[9] The court also expressly contemplated the possibility of a damages remedy against the private equity acquirors and the financial advisor for having "aided and abetted" the breach of fiduciary duty.[10]

Oversight of Advisors

Although it is difficult to imagine how the Del Monte board could have prevented its financial advisor from misleading the board and concealing information about behind-the-scenes negotiations among themselves and the bidders, there are some lessons that directors can derive from this situation. First, it is important that the board request full disclosure of any existing or potential conflicts of interest in connection with the initial retention of an advisor. Once these conflicts are fully disclosed, the board can objectively consider whether these conflicts are disqualifying. In addition, the board should insist that advisors disclose any conflicts of interest that arise during the retention and, on matters such as buy-side financing, consider at the outset whether the financial advisor might be permitted to provide financing to a buyer at the conclusion of the sales process and the impact of any such decision on the process.

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[6] *Id.* at 18. The court noted: "The contemporaneous record does not reflect any consideration given to the ramifications of permitting KKR to team up with the firm who previously submitted the high bid and who could readily have teamed with Carlyle, Apollo, CVC, or another large buyout shop. The Board did not consider rejecting KKR's request, enforcing the confidentiality agreement, and inviting Vestar to participate with a different sponsor to generate competition. The Board did not seek to trade permission for Vestar to pair with KKR for a price increase or other concession." *Id*.

[7] *Id.* at 19-20.

[8] *Id.* at 23. The court noted: "The Strategic Committee delegated the task of running the go-shop to Barclays and had no direct insight into how Barclays interacted with the parties it contacted. Barclays had a strong interest in ensuring that a particular kind of buyer (private equity) acquired Del Monte and a keen desire to see the deal close with KKR." *Id*. at 36-37.

[9] *Id.* at 45.

[10] *Id.* at 3-4.

Moreover, the board should communicate to its advisors at the outset of the engagement that the provisions of any confidentiality agreements must be properly respected and that the advisors will receive and must follow clear instructions from the board. In addition, in retaining a financial advisor, the board should consider asking the advisor whether it has had any contacts with potential buyers and, if so, the content of any such discussion. The *Del Monte* situation is a cautionary example of how perceived passivity can make directors vulnerable to the machinations of self-interested advisors.

In recent years, the Delaware Chancery Court has taken a strong stance against board advisors with real or perceived conflicts of interest. In the 2005 case *In Re Toys "R" Us S'holder Litig*., Vice Chancellor Strine advised "that investment banks representing sellers not create the appearance that they desire buy-side work, especially when it might be that they are more likely to be selected by some buyers for that lucrative role than by others."[11] Vice Chancellor Laster noted that the actions of the board's financial advisor in the Del Monte transaction went "far beyond" the facts of *Toys "R" Us*.[12] And in the 2009 case of *In re John Q. Hammons Inc. S'holder Litig.*, in which an investment advisor attempted unsuccessfully to underwrite the post-merger securities offering, Chancellor Chandler wrote, "This Court ... has stressed the importance of disclosure of potential conflicts of interest of financial advisors. Such disclosure is particularly important where there was no public auction of the Company. It is imperative that stockholders be able to decide for themselves what weight to place on a conflict faced by the financial advisor."[13]

In the *Del Monte* decision, Vice Chancellor Laster made reference to both *Toys "R" Us* and *John Q. Hammons*, noting that "[b]ecause of the central role played by investment banks in the evaluation, exploration, selection, and implementation of strategic alternatives, this Court has required full disclosure of investment banker compensation and potential conflicts. This Court has not stopped at disclosure, however, but rather has examined banker conflicts closely to determine whether they tainted the directors' process."[14] In light of these and similar cases, it is important that the directors of a selling company hold a firm line and fully understand and account for any conflicts of interest—actual, potential or perceived—held or created by its advisors and to take an active role in managing and supervising the advisors rather than relying too heavily on their judgment and acceding too readily to their requests where there may be a conflict. In this context, board minutes should reflect that the directors are active and involved in the oversight of conflicts and in managing key aspects of the sale process. Although this will not eliminate conflicts to the extent that they remain hidden from the board, the directors will be able, in the event of a challenge, to show that they acted appropriately.

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[11] 877 A.2d 975, 1006 n.46 (Del. Ch. 2005).

[12] *Del Monte* at 32.

[13] 2009 WL 3165613 (Del. Ch. 2009) at *16.

[14] *Del Monte* at 30.

Special Committees

Vice Chancellor Laster noted that while "the blame for what took place appears at this preliminary stage to lie with . . . [the board's financial advisor], the buck stops with the Board. Delaware law requires that a board take an 'active and direct role in the sale process.'"[15] In a sale transaction with no conflicts of interest for directors, the whole board should be fully informed and involved in discussions and decisionmaking.

There seems to be a temptation for boards to create a special committee (or a "strategic committee," as was created by Del Monte's board) for every significant transaction involving a potential sale of the company; however, special committees generally are appropriate for transactions involving an actual or potential conflict for a majority of the directors.[16] In situations where only a few directors have an interest in or potential conflict with respect to the transaction, the better course is often for those directors to recuse themselves from discussions and votes on the transaction.

Where no directors are interested or potentially conflicted, the creation of a special committee is a mistake. As Vice Chancellor Laster noted, the board must be active in a sale process; delegating the leadership of the process to a special committee can have the effect of causing some directors to feel distanced from—and perhaps be under-informed about—the details of the process. Moreover, when a special committee is properly formed, it must be independent and have the ability to hire its own financial and legal advisors. While it is important that any potential advisor disclose any conflicts of interest to the board or special committee, they should not be disqualified from representing a special committee or a board simply because they have done work previously for the company. In fact, an advisor that has familiarity with the company but is not unduly conflicted may be more helpful than a advisor who is totally unfamiliar with the company. In this situation, the special committee or board needs to fully understand the extent of the prior work and determine that the prior work does not present a disabling conflict of interest in the context of the current transaction.

The implementation of a special committee structure adds expense and can create a cumbersome layer between the special committee and the full board, since the committee may have information that the board does not possess. While there are situations where special

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[15] *Id.* at 37 (quoting *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 66 (Del. 1989)).

[16] In a challenged transaction involving a controlling stockholder, the use of a special committee requires the plaintiff, rather than the company and its directors, to prove that the transaction was "entirely fair" to the corporation and its stockholders. *Kahn v. Lynch Comm'ns Sys., Inc.*, 638 A.2d 1110, 1121 (Del. 1994). The Delaware Court of Chancery has stated that the approval of a transaction by an effective special committee is itself "powerful evidence of fairness." *In re Cysive, Inc., S'holders Litig.*, 836 A.2d 531, 550 (Del. Ch. 2003) (citing *Weinberger v. UOP, Inc.*, 457 A.2d 701, 703, 709 & n.7 (Del. 1984)).

committees are necessary, there is sometimes a tendency to form special committees in situations where they are not required;[17] this can make the process of negotiating and completing a transaction significantly more complex and create unnecessary divisions between the board and the special committee.

It is crucial that a special committee, in any context, has a clear mandate from the outset. This should be set forth in the board resolutions creating the committee and empowering the committee to hire its own advisors. Any director serving on a special committee must feel comfortable with the committee's goals and be fully engaged in the committee's work. If a director does not fully understand and support the mandate of the special committee or is not comfortable with its authority, he or she should decline to join it. Similarly, if an individual director does not have sufficient time to serve on a special committee, he or she should not participate. These issues need to be sufficiently addressed when the committee is formed to avoid problems later in the process.[18]

Conclusion

As Vice Chancellor Laster pointed out in the *Del Monte* opinion, "This case is difficult because the Board predominantly made decisions that ordinarily would be regarded as falling within the range of reasonableness for purposes of enhanced scrutiny."[19] Indeed, the court noted, "it appears that the Board sought in good faith to fulfill its fiduciary duties, but failed because it was misled."[20] Directors can take some comfort in the fact that Vice Chancellor Laster described the potential of a monetary judgment against the directors as "vanishingly small," but nonetheless, he went on, "while the directors may face little threat of liability, they cannot escape the ramifications of Barclays' misconduct."[21] In the context of a potential sale of

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[17] *See, e.g., Air Products and Chemicals, Inc. v. Airgas, Inc.* C.A. 5429-CC (Del. Ch. Feb. 15, 2011) at 60 (nominees to board elected in a proxy contest sought the formation of a "special negotiating committee") available at courts.delaware.gov/opinions/download.aspx?ID=150850.

[18] If a special committee is formed, it should be done properly: "A fully functioning and effective special committee should have the following attributes: (i) the committee members must be disinterested and independent; (ii) the committee members must understand their mandate; (iii) the committee must have real bargaining power; (iv) the committee must be informed and active; and (v) any advisors to the committee should be competent, disinterested and independent." John Grossbauer & Michael K. Reilly, "Special Committees: A Primer," Corp. Gov. Advisor, Mar./Apr. 2007 available at www.potteranderson.com/news-publications-0-198.html. As noted above, advisors should not be disqualified from representing a special committee simply because they have done work previously for the company so long as the committee is fully informed as to what that prior work consisted of and the committee decides that the prior work does not present a disabling conflict of interest in the context of the current transaction.

[19] *Del Monte* at 2.

[20] *Id.* at 3.

[21] *Id.* at 4.

a company, directors cannot prevent misconduct on the part of their advisors, but they must be actively involved in managing the sale process and supervising their advisors.