Client Alert.

April 27, 2011

The *Del Monte* Decision:
Court Finds Likely Breach of Fiduciary Duties by Board Arising from Actions by Financial Advisor; Postpones Merger Vote and Enjoins Deal Protections

By Michael G. O'Bryan

In litigation over the $5.3 billion LBO of Del Monte Foods Company, the Delaware chancery court postponed for 20 days the shareholder vote on the buyout and prohibited the sponsor group during the postponement from exercising most of the deal protections included in the merger agreement.[1] Following the postponement, Del Monte's shareholders approved the acquisition and it closed.

The court's orders arose from its finding, based on a preliminary record, that there was a reasonable probability that the Del Monte board had breached its fiduciary duties, even though the board had "sought in good faith" to fulfill them, in part because of actions by the board's financial advisor that the financial advisor had concealed from the board. The court also found that the sponsor group likely had aided and abetted the board's breach of fiduciary duty, and, following issuance of the court's opinion, plaintiffs filed claims for aiding and abetting against the financial advisor as well.

The orders surprised many dealmakers, given the court's reluctance previously to enjoin transactions approved by a disinterested board or committee in the absence of disclosure violations or a competing offer. While the full record of the buyout has yet to be developed, the court's opinion is likely to bring further attention to the ongoing discussion of financial advisor independence and to affect how companies engage and work with financial advisors.

BACKGROUND

For purposes of its ruling, the court recited the following as facts, based on the preliminary record presented to it.

Del Monte engaged the financial advisor in early 2010 in part to respond to an unsolicited indication of interest received from a PE firm. Prior to that time, the financial advisor had pitched the idea of an acquisition of Del Monte to various PE firms, including the lead member of the sponsor group, which was one of the financial advisor's "more important" clients. The financial advisor planned to seek a role in providing buy-side financing in any such acquisition, which would generate fees for the financial advisor of around the same amount as the anticipated sell-side advisory fee from Del Monte. The financial advisor did not inform the Del Monte board of these pitches or plans when the board engaged the financial advisor, although the financial advisor noted to the board that it knew many of the entities that might be a buyer.

Targeted Process.

Del Monte began a targeted, non-public process that focused on several large PE firms, as recommended by the financial advisor. News of the process leaked, however, and other bidders, including one strategic company, asked to be, and

[1] *In re Del Monte Foods Company Shareholder Litigation*, Del. Ch. Feb. 14, 2011.

were, included. Interested bidders signed confidentiality agreements that prohibited them from, among other things, discussing the potential transaction with other potential bidders (a “no teaming” provision) or debt financing sources. In March, however, Del Monte, based on the strength of its stand-alone prospects, decided to shut down the process.

Re-Start.

In September, the financial advisor met with the lead member of the sponsor group and with another PE firm that had submitted a higher bid during the earlier process, and suggested that the two could partner together. The two PE firms discussed the potential transaction, in apparent violation of the no teaming provision. The lead member of the sponsor group then approached Del Monte, but, with the financial advisor’s cooperation, did not mention the arrangement with the other PE firm, and moreover the financial advisor worked with the PE firms to conceal the other PE firm’s participation.

The Del Monte board decided to pursue the discussions, but without conducting any further pre-signing market check, and re-engaged the financial advisor. The court noted that a sale of Del Monte would trigger substantial payments to the CEO and CFO, who were considering retirement and would not receive such bonuses if the company were not sold. Reports of the proposed buyout surfaced in the press.

Teaming and Financing Requests.

As the negotiations proceeded, the lead PE firm and the financial advisor raised with the Del Monte board what the court characterized as two “unsavory” requests:

- The lead PE firm asked that it be allowed to team with the other PE firm, without mentioning that it had already been in discussions with the other PE firm.
- The financial advisor, following discussions with the sponsor group, asked that it be allowed to provide buy-side financing. In connection with this request, the financial advisor insisted that Del Monte obtain a second fairness opinion.

The board agreed to both requests, without seeking concessions in return. The parties continued their discussions, including as to price, with the financial advisor negotiating on behalf of Del Monte. The PE firms raised their bid, and the parties signed a merger agreement in November, at a purchase price that implied an approximately 40% premium.

Go-Shop.

The merger agreement allowed Del Monte to conduct a 45-day go-shop. Del Monte did so, with the financial advisor taking the lead. Another investment bank approached Del Monte about running the go-shop, but the financial advisor informed the sponsor group of the other investment bank’s interest and the sponsor group asked the other investment bank to participate in a portion of their financing, after which the other investment bank ceased pursuing the go-shop. No other bidders came forward during that time.

THE COURT’S HOLDINGS

Breach of Fiduciary Duties by the Board.

The court stated that, in an acquisition, the target company board must show that (i) they sought to secure the “best value reasonably available” for their shareholders, and (ii) their actions were reasonable in that regard. The reasonableness standard allows a court to address “inequitable” action even when a board believes it is complying with its duties. The board must take an “active and direct role” in the sale process, and the directors’ advisors play a “pivotal” role.

Here, however, the court found a reasonable likelihood that the board had failed to act reasonably in connection with the sale process, and, in particular:

- The directors failed to provide "the serious oversight that would have checked [the financial advisor's] misconduct."
- It was "not reasonable" for the board to accede to the lead PE firm's request to team with another PE firm that had been the highest bidder in the prior round of solicitations and was the board's "best prospect for price competition," without making any effort to obtain a benefit for the company, such as by suggesting that the other PE firm partner with another company in order to generate competition, or seeking a price increase or other concession.
- It was "unreasonable" for the board to allow the financial advisor to participate in the buy-side finance while still negotiating price, "[w]ithout some justification reasonably related to advancing stockholder interests." The court noted that the board did not ask whether the PE group needed financing from the financial advisor in order to raise the price.
- The financial advisor's actions tainted the go-shop process as well, given the financial advisor's presumed preference to find a buyer that would use it in the buy-side finance. The court explained that it was concerned with the "body language" employed during the go-shop, as well as the substance of what was done.

Risk to Individual Directors.
The court noted that the board had made decisions that "ordinarily would be regarded as falling within the range of reasonableness for purposes of enhanced scrutiny" and that the "blame for what took place appears … to lie with" the financial advisor. However, while the board may have been "misled" or even "deceived" by the financial advisor, "the buck stops with the [b]oard." The court further noted, though, that given (i) the exculpation authorized by Section 102(b)(7) of the Delaware General Corporation Law and (ii) the board's reliance on qualified advisors under Section 141(e) of that Law, the risk to directors of having to pay money damages was "vanishingly small."

Aiding and Abetting by the Sponsor Group.
The court found that the PE firms had "knowingly participated" in the financial advisor's self-interested activities, including the violation of the no-teaming provision and the creation of the financial advisor's buy-side conflict. The court noted that the PE firms did not have the same protections as the board under the Delaware statute, and so the prospects for recovery against the PE firms were "not so remote" as those against the directors.

Aiding and Abetting by the Financial Advisor.
The financial advisor was not named in the litigation at the time of the court's opinion. However, plaintiffs since have added the financial advisor to their complaint.

Disclosure Issues.
The court found that Del Monte's proxy statement initially contained disclosures that were false and misleading, in part because of the concealment by the financial advisor of some of its actions. After discovery in this litigation, however, Del Monte issued a supplement to its proxy, including additional information about the financial advisor's actions, which "mooted" the disclosure claims.

CONCLUSION

The opinion demonstrates the continued sensitivity of courts to conflicts of interest, including amongst advisors and others who act to inform an otherwise disinterested board. This sensitivity is particularly acute in PE buyouts where management might be expected to play a continuing role with the buyers, though in this case the "taint" came primarily from "a conflicted financial advisor rather than from management."

As boards engage and work with financial advisors, they should ask questions about the advisor's relationships and motivations. Not all existing or desired relationships will be unresolvable conflicts; indeed, such relationships could be used to the advantage of the target and its shareholders. However, the board should demonstrate its understanding of the factual setting and the potential pitfalls, and take steps to understand and manage such relationships and motivations.

In particular, boards should be careful in considering whether to allow:

- *Participation by their financial advisor in buy-side financing* – Such arrangements at times may help the shareholders, such as by helping to get a deal process moving more quickly, or allowing a bidder better access to leverage so that it can increase its price. However, the board should consider the potential impact of the conflict as well, particularly if allowed or considered prior to the time that the price for the transaction is finalized.
- *Teaming between two potential buyers* – Such coordination between otherwise potentially competing buyers may at times benefit the shareholders, such as by allowing the bidders to pool their resources and bid more, but also can reduce, or appear to reduce, the competition between the bidders and thus the ultimate price.

Disclosure to shareholders was "mooted" as an issue in this opinion by the proxy supplement, but disclosure of potential conflicts with respect to financial and other advisors, and with respect to deal processes more generally, remains an area of concern, and action, for courts.

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