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Tainting The Sales Process

Law360, New York (March 18, 2011) -- In In re Del Monte Foods Company Shareholders Litigation, Consol. C.A. No. 6027-VCL (Del. Ch. Feb. 14, 2011), the Court of Chancery temporarily enjoined a shareholder vote on a high premium, all-cash merger to require an additional 20-day market check based on a preliminary finding that the sale process was potentially tainted by alleged misconduct by Del Monte's financial adviser and the private equity buyers.

The court also enjoined the parties from enforcing the buyer's deal protections and left open the door for a monetary damages claim against the buying consortium as an "aider and abettor" of a fiduciary breach by Del Monte's Board.

On a preliminary record, the court found that the Del Monte Board was so misled by its financial adviser, which "secretly and selfishly manipulated the sale process," as to have been unable to properly discharge its fiduciary obligations despite its good faith efforts to do so.

In a strongly worded opinion, the court put the investment banking and private equity community on notice that Delaware "has a strong interest in policing the behavior of fiduciaries ..." particularly when the sale processes involve, in the court's view, "illicit behavior, [which] is secretive and subversive, yet appears to elicit yawns from Wall Street players who regard it as par for the course."

Writing for the court, Vice Chancellor Laster unflatteringly described the back room dealing of a coverage banker who put Del Monte into play and then, notwithstanding having been directed by Del Monte to "shut the process down," later reignited bidding by "surreptitious[ly]," and in contravention of an anti-teaming provision, steering the former high bidder into a club with the potential bidder with whom the adviser had the strongest relationship. The adviser also concealed its role in the pairing from the Del Monte Board for several months.

The court found particular fault with the fact that, prior to a final price having been negotiated, Del Monte permitted its financial adviser to provide one third of the buy-side financing, a role which the court observed (1) the adviser intended to have from the outset but which was not disclosed to the board, (2) created a direct conflict of interest with Del Monte, (3) was not needed by the buyer to close the deal and (4) potentially generated more fees for the financial adviser than did its role as Del Monte's sell-side adviser.

The court remarked that Del Monte's financial adviser "on multiple occasions ... protected its own interests by withholding information from the Board that could have led Del Monte to retain a different bank, pursue a different alternative, or deny [its adviser] a buyside role."

Acknowledging the central role that investment banks play in the sale process, the court nonetheless admonished that “the buck stops with the Board” and Delaware law requires that a board take an “active and direct role in the sale process.” Where, as in Del Monte, “subtle structural or situational conflicts” arise, even if there is no evidence of self-interest or undue favoritism by the board, the reasonableness of the decisions in light of the circumstances will be subject to judicial scrutiny.

In concluding that the plaintiff had shown a reasonable probability of success on its claim to warrant the injunctive relief, the court found that, despite being misled by its adviser, the Del Monte Board failed to act reasonably in overseeing its adviser and improperly (1) permitted the competing bidders to work together, thereby “giving up its best prospect for price competition without making any effort to obtain a benefit for Del Monte and its stockholders,” (2) acceded to its adviser’s request to provide buy-side financing prior to a final price having been agreed with the buyout firms, and (3) allowed its adviser to run the go-shop process despite its self-interest (as a provider of buy-side financing) in the success of the bidding consortium.

Although the court held that the “burden of [the] uncertainty” associated with a tainted process “must rest with the fiduciaries who created it,” the burden of the Del Monte decision ultimately fell most severely not on the Del Monte directors — who the court acknowledged are likely insulated from claims for monetary damages by exculpatory provisions of Delaware Law — but on the bidding buyout group.

Not only did the court deny the buyer the benefit of the undoubtedly carefully negotiated deal protections (including termination fee and matching right provisions), but the court found on the preliminary record that the plaintiffs had established a reasonable likelihood of success on the merits of their claim that the bidding buyout group aided and abetted the board’s breach of its fiduciary duties. Moreover, the court warned that “disgorgement of transaction — related profits may be available” against the buying consortium for its “knowing participation” in the adviser’s misconduct.

The decision sounds an important cautionary note for bidders for control of a public company. Delaware courts will scrutinize closely the sale process and will not tolerate a bidder implicitly or explicitly interfering with the seller’s process. Taken together with Vice Chancellor Strine’s comments in Toys “R” Us, the Del Monte decision makes clear that participation by sell-side advisers in buy-side financings will draw particular scrutiny.

In the wake of these decisions, buyout sponsors should be advised not only strictly to adhere to the seller’s bidding procedures, including anti-teaming provisions, but also to steer clear of activity that may be perceived as creating or exploiting a conflict of interest between (1) the seller and (2) its advisers, prospective advisers, management team and others involved in the deal, unless there is a clear value proposition for the selling shareholders.

Facilitating a conflict of interest not only puts the buyer’s deal protections at risk, but also potentially exposes the buyer to monetary damages for aiding and abetting claims.

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