Managing Conflicts of Interest and Disclosure

Transactions, including mergers and sales, require management-stockholder interest transparency.

BY DOUG RAYMOND

A decision from the Delaware Supreme Court this summer highlighted the importance that boards set clear guidelines when considering a transaction in which the interests of management might diverge from those of the stockholders, as in a sale of the company.

The case, *Morrison v. Berry*, involved a bid to purchase supermarket chain The Fresh Market and disclosure failures on the part of management. In the Morrison decision, the Chancery Court dismissed the plaintiff's claim that the board had breached its fiduciary duties, relying on the "cleansing" stockholder vote approving the transaction. The Supreme Court reversed the ruling; providing a "cautionary reminder" on how to approach a significant transaction and avoid risking potential and unnecessary stockholder litigation.

In 2015 The Fresh Market received an unsolicited takeover proposal from Apollo Global Management LLC. In its offer, Apollo disclosed that it had discussed with Ray Berry, the company's founder, about whether he would agree to roll his 10 percent ownership equity into the deal instead of selling his shares for cash along with the other stockholders.

Though the founder — who was also on the board — had recused himself from the board decision regarding the bid, he did advise the board that he had no agreement with Apollo regarding the transaction. Apollo ultimately entered into an agreement to acquire the company, and stockholder approval of the transaction was sought.

It was later revealed that before Apollo made its offer, the founder had been in contact with representatives from Apollo and had supported their proposal, a fact that was not apparent from the public disclosures regarding the transaction.

The court found that the documents that had been sent to the stockholders describing the transaction had misrepresented significant matters which, if properly disclosed, would have helped the stockholders to reach a "materially more accurate assessment of the probative value of the sale process."

The misrepresentations

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included failure to disclose the following:

• Before the board had considered Apollo's proposal, the founder had agreed to roll his equity interest into the deal, putting him on the same side of the table as the buyer;

• The founder had suggested to the board that, in light of the low valuation and changes in the business, the board should pursue a sale of the company, and that if the company remained public he would strongly consider selling his shares because the company was not "well-positioned to prosper as a public company." However, the company did not disclose that he took these positions after having agreed to the equity rollover transaction with Apollo; and

• The company's public filings reported that the founder was willing to consider offers from other parties. However, the filings failed to disclose that the founder had already agreed to roll his equity in the Apollo transaction or that he had previously told the board that he did not know of any private equity funds other than Apollo with which he would consider rolling over his equity.

The Chancery Court had held that these disclosure failures would not have made stockholders less likely to sell their shares in the tender offer. However, the Delaware Supreme Court found that this was not the proper test. Instead, at issue was whether "there is a substantial likelihood that a reasonable stockholder would have considered the omitted information important when deciding whether to tender her shares or seek appraisal."

Lessons learned

Morrison v. Berry follows a plot line that has spawned a raft of cases over the years. An offer is floated to the CEO by a banker, a private equity fund or even by a competitor, accompanied by some clear indications that the transaction would include other benefits for the management team. The CEO then champions the deal and, in more-or-less overt ways, tilts the playing field toward his or her new friends and away from other possible bidders who may not be as generous.

Morrison serves as a reminder that boards and CEOs should tread carefully when approaching the negotiation of a significant transaction in which the CEO or management could have a conflict of interest.

Boards and CEOs should consider the following when negotiating a transaction:

• Be clear about any benefits offered to management that are not available to all stockholders and discourage a possible bidder from entering discussions that could take them down that path before the primary transaction has been negotiated.

• If a conflict develops, the conflicted parties must advise the board and its lawyers so adequate measures can be implemented to address the conflict. For example, a conflicted CEO should stay clear of negotiating the primary transaction.

• Any public filings around a transaction involving a management conflict should include clear and complete disclosures about the conflicts, so that the board and the transaction can be best protected from later challenges.

The protection of the Delaware cases that allow a disinterested stockholder vote to "cleanse" purported breaches of fiduciary duty, come at a price. This protection requires that the stockholder vote has been by fully informed and disinterested stockholders have been properly apprised of potential conflicts of interest. Knowing that these disclosures must be made should help boards and management handle potential conflicts when (or before) they arise, and thus prevent awkward disclosures or embarrassing and expensive post-closing litigation. ■

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