

Snyder's-Lance Inc. Snacks on a Troubled Diamond

Foods and Now Campbell's Soup Simmers: It's Complicated

INTRODUCTION

Diamond Foods, a nut and snack company, was founded in 1912 by a walnut grove cooperative known as "Diamond of California." Over the years, Diamond Foods grew by acquiring other brands, including *Pop Secret*, *Kettle Foods*, and *Harmony Foods*. It also introduced another nut product under the brand name *Emerald*. Until recently, the company was owned by Snyder's-Lance and was headquartered in Charlotte, North Carolina.

After an SEC investigation at Diamond, Snyder's-Lance purchased the company for \$1.91 billion in a cash-and-stock deal. In addition to Diamond, the Snyder's-Lance product line includes the brands *Cape Cod*, *Lance*, *Tom's*, *Eat-Smart*, *Stella D'ora*, *Kruncherst*, *Late July*, *Archway*, *Oke-Doke*, *Pretzel Chips*, *Snyder's of Hanover*, *Kettle Brand* and *Jay's*. Currently there are 6,400 full-time employees. Snyder's-Lance's biggest competitors are Kellogg, U.S.A.; Frito-Lay, USA Inc.; and Mondeleze International, Inc.

THE DIAMOND FOOD SCANDAL

Prior to being acquired by Snyder's-Lance, Diamond Foods was involved in a scandal in which financial reports were falsified. The fraud originated in 2005 when Michael Mendes was President and CEO. His management philosophy was "Bigger is Better," which ultimately led to a corporate culture filled with bad judgment and fraud. As part of his growth strategy, he secured millions in loans to finance the acquisition of *Pop Secret*. He later unsuccessfully attempted to purchase *Pringles* from Proctor and Gamble. Had that merger been gone through, Diamond Foods would have been the second largest distributor of snack foods in the United States following PepsiCo.

In 2011, Mark Roberts, an analyst with the Off-Wall Street Consulting Group, raised questions about Diamond's accounting practices. He accused Diamond of incorrectly reporting its payment to suppliers. Diamond would pay growers in September for walnuts that were delivered earlier in the 2011 fiscal year, which had ended in July. This significantly impacted Diamond's financial statements, which, if done intentionally, would be illegal. Initially, their fraud resulted from a lack of quality controls and from the inability or unwillingness of top management to set proper ethical standards. After the payment irregularities were discovered, Diamond's management denied they were for the previous year's crops. They contended the payments were an advance on the future 2012 crop to "optimize cash flow for the growers."

This case was prepared by Dianne Kroncke and edited by Shelby Wyatt for and under the direction of O.C. Ferrell and Linda Ferrell. It was prepared for classroom discussion rather than to illustrate either effective or ineffective handling of an administrative, ethical, or legal decision by management. All sources used for this case were obtained through publicly available material. ©2018

The growers refuted this claim and ensured investigators that the payments were, in fact, for the previous year. Audits revealed that these payments were made to inflate the fiscal 2011 results by shifting costs into the upcoming year. An internal investigation found that CEO Michael Mendes and CFO Steven Neil had systematically improperly accounted for growers payments in 2010, 2011 and 2012. By skewing Diamond's financial results and shifting costs into the upcoming year, they reported an EPS of \$2.61 when the correct number was \$1.14. As a result, they took home millions of dollars in additional compensation that they were not entitled to claim.

In addition to inflated compensation, Diamond also needed this increased financial performance in order to attempt the acquisition of *Pringles*. For example, the "improved" EPS resulting from the accounting fraud would help them to acquire *Pringles* and permit Diamond to meet other conditions laid down in the loan covenants. One of these conditions required performance standards that affected management compensation. Therefore, a higher reported earnings would, in return, allow for greater compensation. The improper accounting of earnings was an attempt by management to deceive the lenders about Diamond's true earnings. Later, the company was investigated for criminal fraud, and a new audit was undertaken. This further disrupted the *Pringle* acquisition process, which already suffered delays due to Diamond's difficulty in meeting earlier financial reporting deadlines.

Around the same time, another ethical concern arose regarding a conflict of interest within the company. Diamond's CFO also had a seat on the company's Board of Directors, which can lead to a lack of oversight by the Board regarding various company issues. The lack of quality controls and the inability or unwillingness of top management to set proper ethical standards further created a culture that encouraged employee unethical behavior.

Diamond's stock price dropped to a six-year low of \$12.50, upon completion of the audit. The restated financial results decreased profits by \$56.5 million. The price decline was also impacted by rumors that billionaire investor and activist, David Einhorn, was shorting the stock. Investor uncertainty about Diamond's future profitability increased, and the *Pringle* deal with Proctor and Gamble collapsed.

Following the SEC investigation, Mendes and Neil were placed on administrative leave. Mendes subsequently resigned, and Neil was let go. Mendes did not receive promised insurance benefits as his resignation was considered a violation of his duty as CEO. He was required to repay his 2010 and 2011 bonuses, which totaled \$2,743,400 and had to pay back the 6,665 shares of Diamond common stock that he received from fiscal year 2010. Although this amount was taken from his Retirement Restoration Plan, he ultimately still received a payment of \$2,696,000.

After restating its profits, the company still faced risks of litigation, regulatory proceedings, government enforcement and insurance claims. The SEC levied a \$5 million fine as settlement of the fraud allegations. The SEC charged Neil for falsifying walnut costs and Mendes for his role in the misleading financial statements. Mendes forfeited \$4 million in bonuses and benefits and paid a penalty of \$125,000. Though it was not proven that Mendes participated in

the scheme, regulatory authorities believed he should have known about Diamond's incorrect financial statements. Neil initially fought the SEC charges but eventually settled by paying a civil penalty of \$125,000. Investors filed lawsuits against Diamond because of the misrepresentation of its financial standing; a \$100 million settlement was made by Diamond Foods.

SNYDER'S-LANCE TAKES OWNERSHIP OF DIAMOND

Brian Driscoll took over Diamond as the President and CEO in 2012 after the Michael Mendes and Steven Neil were let go. He outlined a strategic plan to advance the company past its ethical mistakes. The plan began with improved internal controls of financial statements and six new directors appointed to strengthen the Board. A forward-looking statement of risks was issued, which identified problems that may arise in the future. It also included the "Diamond Food Company Code of Conduct and Ethics Policy," and a statement about top management's responsibility in setting the proper tone for the organization.

He replaced the CFO and installed new company financial reporting processes in which managerial approval was needed for material and non-routine transactions. Ethics training, led by the CFO, reinforced proper accounting procedures and training for employees. It led to a better understanding of financial reporting integrity and ethical expectations. He modified the walnut cost estimation policy and added inputs each quarter, which had to be reviewed and signed off on by cross-functional management. His efforts created a system of better documentation and oversight of accounting procedures and improved supplier communication. A Grower Advisory Board was introduced to receive input from the growers and enhance communication between growers and the company. Diamond followed the Sarbanes-Oxley internal control policies involved with grower accounting procedures.

The controls on accounts payable and invoice processing were revised. A third-party report known as "Internal Control-Integrated Framework," evaluated the effectiveness of its internal controls. The reporting controls were implemented and improved communication which, in turn, created better transparency. These new controls enabled the company to escape bankruptcy and restore shareholder confidence, which ultimately led to the Snyder's-Lance merger.

Shortly following the turmoil brought on by the scandal and the SEC officially charging Diamond Foods with fraud in January, 2014, the firm entered into merger talks with Snyder's-Lance, Kellogg and other major food manufactures. On February 29, 2016, Snyder's-Lance announced the completed acquisition of Diamond Foods in a cash and stock merger transaction valued at over \$1.9 billion. This merger and the success of Diamond Foods following the scandal can largely be attributed to the leadership of Brian Driscoll.

Driscoll's strategy and ethical thinking paid off and in June, 2017, he became the CEO and President of Snyder's-Lance, Inc. Under Brian Driscoll's leadership, Snyder's-Lance has an Ethical Code of Conduct with questions and answers on the webpage.

CAMPBELL'S SOUP TAKES OWNERSHIP OF SNYDER'S-LANCE

The Campbell Soup Company has been in operation since 1932 and is headquartered in Camden, NJ. Denise Morrison is President and CEO, a position she has held since 2010. Under her guidance, the traditional "real and authentic" soup brand has been expanded to include *Boathouse Farms*, *Campbell's Canada*, *Campbell's Chunky*, *Garden Fresh Gourmet and Salsa*, *Kelsen*, *Campbell's Food Service*, *Stock Pot*, *Goldfish*, *Pepperidge Farm*, *Plum*, *Prego*, *Spaghetti O's*, *Swanson*, *V8*, and *Arnott's Tim Tam Biscuits*.

Campbell's has experienced declining sales in recent years as many of today's consumers continue to seek less processed food products. This has led Campbell's to seek new markets and additional customer bases. Denise Morrison is driven to lead change and engage in strategic growth. When questioned about the management plan at Campbell's, Morrison said, "To realize our strategic vision, we must fulfill a dual mandate. We committed ourselves to work diligently and creatively to expand into higher-growth spaces, to engage with new consumers and to build our business in new geographies."

December 2017 was a busy time for the soup maker as Pacific Foods (an organic broth and food line) was added to the company for \$700 million in cash. In a surprising move on December 14, 2017, the company announced they were purchasing the snack company, Snyder's-Lance for \$4.87 billion. Brian Driscoll, the Snyder's-Lance CEO said, "This was the best option for Snyder's-Lance shareholders." Should the deal be completed, the Snyder's-Lance headquarters would no longer be in Charlotte, NC. Since the announcement, eight lawsuits have been filed by Snyder's-Lance shareholders who believe the stock purchase price of \$50.00 a share is undervalued. The lawsuits call into question whether Snyder's-Lance senior management was "entering into the deal for their own self-interests." With the investigation underway, Moody's Investors Services announced it will review Campbell for a possible credit downgrade because of the \$6.2 billion in debt the company intended to take on to close the transaction.

For Campbell's to complete the acquisition, Morrison would need to "thin the soup" by cutting \$170 million in annual costs from the combined operations by 2022. It is believed much of the cost cutting would be from the Snyder's-Lance division. According to Bloomberg data, "Any deal would likely require the blessing of the founding family of Snyder's Bakery, which owns a combined stake of almost 17 percent," while the Campbell's Soup deal continued to simmer.

On March 26th, 2018, Campbell's Soup completed the acquisition of Snyder's-Lance for \$50 per share in an all-cash transaction. The total enterprise value of the deal amounted to \$6.1 billion. Upon completion of the deal, Morrison assured stockholders about the combination of synergies and potential revenue growth along with a note to consumers about how "the combination of Campbell and Snyder's-Lance creates a unique, diversified snacking portfolio of differentiated brands and a large variety of better-for-you snacks for consumers." The future for Campbell's might be held in a combination of Pepperidge Farm and Snyder's-Lance portfolios to create a new snacking organization called Campbell Snacks. With the ethics and compliance issues of some of their current portfolio, it is important for Campbell's to provide strong leadership for a synchronized ethical culture. For employees at Diamond Foods, they have experienced a large amount of change in their organizational culture. There will be a need for a focus on ethical conduct in their new environment.

QUESTIONS

1. How did weaknesses in Diamond Foods' internal controls contribute to the accounting scandal?

2. What were some of the signals that the ethical culture of Diamond Foods was weak?
3. How will Diamond Foods sale to Snyder's-Lance and then Campbell's Soup impact their ethical culture?

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