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How Hershey Went Sour

Lack of Communication, Trust Alienated Firm From Key Holder

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By June, for the first time in decades, there will be a big new stand-alone candy maker: Cadbury. But its architects had intended to add another iconic brand to the name -- Hershey.

A little over a year ago, Todd Stitzer, chief executive of Cadbury Schweppes PLC, of the United Kingdom, sat down in the Ritz-Carlton Grande Lakes hotel in Orlando, Fla., with Richard Lenny, his counterpart at Hershey Co. , to suggest the two executives create a "global confectionery powerhouse."

BACK AND FORTH

"We disagree with much that is in the letter, including your self-serving version of events and selective use of facts, but we see no useful purpose served by a continuing exchange of letters."

-- Hershey Co.'s board of directors to the directors of the Hershey Trust.

Read the full text of the letters .

The encounter set off a chain reaction that has left Cadbury, which has since agreed to spin off its beverage business, on its own and Hershey firmly in the grip of its largest shareholder, a secretive charitable organization called the Hershey Trust Co. The events culminated in the fall with the resignation of Mr. Lenny and the subsequent departure of eight Hershey directors in what a local newspaper dubbed "the Sunday night massacre."

The Pennsylvania chocolatier faces a host of challenges. Hershey's earnings have deteriorated and the company has been losing market share to rival Mars Inc. Its stock price has fallen about 31% in the past 12 months, closing at $36.84 Friday on the New York Stock Exchange, while the Dow Jones Wilshire U.S. Food and Beverage Index is up 5.6% over that same period. Hershey also is one of several candy companies under a price-fixing probe by antitrust authorities in the U.S., Canada and Europe.

Hershey's downward spiral offers an illustration of how a breakdown in communication and trust among a company's main actors -- management, the board of directors and key shareholders -- can paralyze an organization and leave it vulnerable. As Hershey Trust

Chairman LeRoy Zimmerman wrote in an October letter to Hershey Co.'s board: "The lifeblood of collaboration is truth."

In 1909, company founder Milton Hershey established a school for orphans and later transferred his wealth, including his ownership stake in the company, to the Hershey Trust Co., which administers the school's trust. Few trusts hold substantial equity in public companies anymore, and those that do rarely seek to wield much influence over them.

The Hershey Trust became aggressive after concluding Mr. Lenny had kept it in the dark about Cadbury and the company's declining financial fortunes. Now, the future of Hershey and its hometown, population 12,771, according to the 2000 census, lies squarely in the trust's hands. The trust, whose board is dominated by local elites, owns almost 30% of Hershey's stock, controls about 79% of the voting shares and has the legal authority to appoint or remove up to five-sixths of the company's directors.

The trust would like to find an international partner like Cadbury that would help solve Hershey's biggest problem -- reliance on the U.S., which accounts for more than 80% of its revenue. So far, that hasn't happened.

Cadbury and Hershey had flirted for decades. But Hershey had insisted on doing a deal on equal footing, and the two sides were never able to agree on how to handle Cadbury's drinks business, which made it considerably larger than Hershey.

Armed with a nearly 30-page presentation, Mr. Stitzer told Mr. Lenny in Florida in January, 2007, that Cadbury's board was ready to remove that stumbling block by getting rid of the drinks division, people familiar with the matter said. He also offered to register the company in Delaware, put headquarters in Hershey and maintain a U.S. stock listing.

Under the plan, Mr. Stitzer would be CEO of the new company and Mr. Lenny chairman, the people said. Mr. Lenny told Mr. Stitzer that he would consult his board and get back to him.

Exactly when Messrs. Stitzer and Lenny next spoke and what was said is a matter of dispute. What is clear is that merger talks between the two never got off the ground.

Mr. Lenny waited for the Hershey board's next regular meeting Feb. 13, 2007, to address the issue. He raised it late in the session, and the discussion was short. Some directors left not realizing the approach had been serious, people familiar with the matter said.

In mid-March, Mr. Stitzer announced Cadbury would jettison its drinks business, which makes Dr Pepper and 7 UP. Two weeks later, he told analysts in London a merger with Hershey would make sense. The news piqued the interest of Robert Vowler, the trust's liaison to the company who met quarterly with Mr. Lenny.

Relations between Mr. Vowler, who manages the trust's day-to-day operations from the limestone mansion in Hershey where the company's founder used to live, and Mr. Lenny have been cool for years. In 2002, the trust decided to sell Hershey and then reversed course just as Mr. Lenny was about to sign an agreement with Wm. Wrigley Jr. Co. It was Mr. Vowler who called Mr. Lenny to tell him the trust was pulling the plug.

So when Mr. Vowler reached out to Mr. Lenny last April to ask about Hershey's position on Cadbury, things didn't go well. It was only then that Mr. Lenny told him that he had gotten a proposal from Mr. Stitzer, said a person familiar with the matter. In a series of testy exchanges, Mr. Vowler accused the CEO of intentionally withholding information from the trust, according to people familiar with the matter.

Mr. Lenny responded that it was the responsibility of the trust's representative on the Hershey board to tell the trust, not his. That representative, Robert Cavanaugh, didn't notify the trust because he didn't know how detailed the Cadbury proposal was, said a person familiar with the matter.

So upset was Mr. Vowler that Mr. Lenny had discussed a merger with Cadbury without engaging the trust that he recruited former Hershey executive Robert Reese to advise the trust on the potential merits of a Cadbury deal.

Mr. Reese is a grandson of the man who created the eponymous peanut butter cups; Hershey bought the H.B. Reese Candy Co. in 1963, and Mr. Reese worked as a lawyer at Hershey from 1978 to 2002. In the late 1980s, he worked with Mr. Stitzer on a deal that gave Hershey the rights to sell Cadbury chocolates in the U.S.

Working out of an office in the Hershey mansion, Mr. Reese called Hershey employees with questions about the company. Mr. Reese, in a written statement, said he began advising the trust last April "on a variety of matters."

When the company reported a disappointing second quarter in July, the trust board felt blindsided, said people familiar with the matter. Once again, Mr. Lenny had withheld key information, they believed.

By September, Hershey stock was down about 7% for the year. As Hershey's profits and market capitalization had declined since the stock's peak in 2005, the trust had seen the value of its holdings decrease more than $1 billion.

Early in September, the trust took the Cadbury matter into its own hands. Trust and Cadbury representatives met at the Palace Hotel in New York City; Mr. Lenny wasn't invited, though Jon Boscia, a Hershey company board member, was.

But things had changed. The credit crisis had made a sale of Cadbury's beverage business much less certain, and Hershey's declining performance made the company look less attractive. The talks went nowhere. On Oct. 1, Mr. Lenny called trust Chairman Mr. Zimmerman and said he was going to "retire."

The next day, Hershey Co. announced Mr. Lenny's right-hand man, Chief Operating Officer David West, would become CEO Dec. 1. Trust board members believed Mr. West would be an interim CEO, according to a letter the trust later wrote to the Hershey board. But a few days later, the trust learned from a regulatory filing that the company board had signed Mr. West to a three-year contract. People close to the company insist the trust knew Mr. West would be signed on as the permanent CEO.

In either case, the trust again felt betrayed. On Oct. 10, Mr. Zimmerman issued a public statement on behalf of the trust in which he said the shareholder was "not satisfied with the company's results."

About a week later, Hershey reported third-quarter earnings had fallen 66%. Mr. Zimmerman arranged for a conference call with Mr. Boscia and Hershey director Robert Campbell, who worked most closely with the trust's board. Mr. Zimmerman demanded they resign and that four trust nominees be added to the Hershey board by the close of business Oct. 22.

The Hershey board agreed to the trust nominees but not the resignations. If the trust forced the resignations, the board said, the other directors, with the exception of the trust's representative, Mr. Cavanaugh, would quit, too. The board had drawn its line in the sand.

On Nov. 9, the trust board decided to cross it. It demanded and received the resignations of Messrs. Campbell and Boscia, along with four other directors. Two other independent directors resigned on their own.

On Sunday, Nov. 11, the trust announced their successors.

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