SULLIVAN & CROMWELL LLP

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In re Southern Peru Copper Corporation Shareholder Derivative Litigation

Delaware Chancery Court Finds Acquisition by Southern Peru Copper of a Subsidiary Owned by Its Controlling Shareholder Did Not Satisfy Entire Fairness and Awards $1.26 Billion in Damages

SUMMARY

In its recent *Southern Peru* decision, the Delaware Chancery Court found that the process undertaken and the price paid by Southern Peru, a NYSE listed company, for the purchase of Minera, a private company, from its controlling stockholder was not entirely fair. Opining that the Southern Peru Special Committee entered “the altered state of a controlled mindset” and allowed Grupo Mexico, the controlling shareholder of Southern Peru, to impose on Southern Peru its desired purchase of Minera at its chosen purchase price, the court awarded the plaintiffs $1.26 billion in damages. The *Southern Peru* decision, which sets out Chancellor Strine’s views on the dynamics of controlled board situations, highlights the exacting nature of entire fairness review and serves as a reminder of the consequent need for detailed and thoughtful attention to process in a transaction between a controlling shareholder and its controlled public entity. The *Southern Peru* court found that the Special Committee’s conduct did not adequately replicate the arm’s-length negotiation that defines a well-functioning Special Committee and thereby failed to shift the burden of proof on the question of entire fairness to the plaintiffs. At the same time, the court made clear that even if the burden of proof had shifted, the result would have been the same since the standard of proof is a preponderance of the evidence and the court was not “stuck in equipoise” on the issue of entire fairness in the case. The decision also confirmed precedent that a majority of the minority vote does not shift the burden unless it is both fully informed and an actual condition to the transaction, which it was not in the *Southern Peru* transaction. The decision makes clear what is already well established in Delaware—that entire fairness requires a Special Committee that is rigorous and displays real bargaining power, including the ability to say no to the proposed transaction. The court was critical of the Special Committee’s willingness to accept a transaction based on relative valuations, particularly

given the Special Committee's failure to push for a transaction based on Minera's standalone valuation and Southern Peru's market value, its failure to pursue analyses that might have supported higher valuations for Southern Peru while pursuing such analyses of Minera, its failure to pursue alternative transaction structures in order to test the proposition that Minera was undervalued, and its failure to reconsider its recommendation before the shareholder vote in light of Southern Peru's disproportionately strong financial results in the period after the transaction was agreed.

BACKGROUND

On February 3, 2004, Grupo Mexico, S.A.B. de C.V. ("Grupo Mexico") proposed that Southern Peru Copper Corporation ("Southern Peru"), a NYSE listed company, buy Grupo Mexico's 99.15% stake in Minera Mexico, S.A. de C.V. ("Minera"), a private company, for 72.3 million newly issued Southern Peru shares with a market value at that time of $3.05 billion.

Grupo Mexico controlled Southern Peru, owning 54.17% of its shares and 63% of its voting power and designating a majority of its Board of Directors (the "Board"). Two companies unaffiliated with Grupo Mexico, Cerro Trading Company, Inc. ("Cerro") and Phelps Dodge Corporation ("Phelps Dodge"), owned 14.20% and 13.95%, respectively, of Southern Peru's shares.

The Board formed a special committee (the "Special Committee") of four directors, including one from Cerro, to evaluate the proposal. Each of these directors was deemed to be independent of Grupo Mexico and otherwise disinterested. The Special Committee retained financial and legal advisors and a specialized mining consultant and over the next eight months evaluated and negotiated Grupo Mexico's proposal for the Minera acquisition.

On October 21, 2004, the Special Committee unanimously recommended, with the Cerro representative abstaining, and the Board approved, an agreement under which Southern Peru would purchase Grupo Mexico's stake in Minera for 67.2 million newly issued Southern Peru shares with a market value at that time of $3.12 billion. The agreement was conditioned on the approval of holders of two-thirds of the outstanding shares of Southern Peru (including Grupo Mexico), but was not conditioned on the approval of holders of a majority of the outstanding shares not affiliated with Grupo Mexico. Cerro indicated its intention to vote its shares in favor of the transaction, unless the Special Committee withdrew its recommendation, in which case it was committed to vote against the transaction. On the day that the Special Committee approved the transaction, Grupo Mexico agreed to cause Southern Peru to grant Cerro the registration rights it had been seeking for its Southern Peru shares.

Between the execution and closing of the agreement, Southern Peru significantly outperformed its financial projections and the market value of its shares increased from $46.41 to $55.80 per share. Southern Peru's outperformance was significantly greater than that of Minera, which also performed better than had been projected at the time the transaction was agreed. On March 28, 2005, when the stockholders voted to approve the transaction, the 67.2 million newly issued Southern Peru shares had a market value of approximately $3.75 billion. The holders of more than 90% of the Southern Peru shares, including Grupo Mexico, Cerro and Phelps Dodge, voted to approve the transaction.

The plaintiff brought suit derivatively in late 2004 against Grupo Mexico and the directors of Southern Peru. The case moved slowly, and the plaintiff did not move for summary judgment until June 30, 2010. The independent directors were dismissed from the case on December 21, 2010 because the court found that no breach had been alleged against them for which they were not exculpated by the Southern Peru charter.[1] The absence in the record before the court of minutes of many Special Committee meetings, including all minutes of meetings held after July 20, 2004, together with the passage of almost seven years, may have complicated the ability of defendants to justify decisions.

Both parties agreed, and the court accepted, that "entire fairness"—showing that the transaction was entirely fair in process and price to the unaffiliated stockholders—was the appropriate standard of review for the transaction under Delaware law since Southern Peru acquired a corporation controlled by its controlling shareholder.[2]

On October 14, 2011, Chancellor Strine found that the transaction was not entirely fair to Southern Peru; the Grupo Mexico-affiliated directors had breached their fiduciary duty of loyalty and Southern Peru was entitled to $1.263 billion in damages, plus interest.[3]

THE CHANCERY COURT'S OPINION

Chancellor Strine's opinion demonstrates the rigor and exacting nature of entire fairness review, especially in contrast to the deference accorded to the decisions of a board under business judgment review. Virtually every step taken by the Special Committee was reviewed and second-guessed by the court.

A. DEFENDANTS NOT ENTITLED TO SHIFT THE BURDEN OF PERSUASION

Under Delaware "entire fairness" precepts, the burden of showing that the transaction being challenged is entirely fair rests in the first instance with the defendant directors. Those defendants may shift the burden of persuasion by showing that the transaction either was approved by an effective special committee of independent directors or "by an informed vote of the majority of the minority shareholders."[4] In *Southern Peru*, Chancellor Strine held that, in his view, existing case law requires a finding that a special committee

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1 *In re Southern Peru Copper Corporation Shareholder Derivative Litigation*, C.A. No. 961-CS, slip op. at 43 (Del. Ch. Oct. 14, 2011).

2 *Id*. at 46. *See also Kahn* v. *Tremont Corp*., 694 A.2d 422 (Del. 1997).

3 *Id*. at 93, 104-105.

4 *Southern Peru*, at 48-52. *See also Kahn* v. *Lynch Commc'n Sys., Inc.*, 638 A.2d 1110 (Del. 1994).

is also "well functioning" before the burden can shift.[5] Applying this analysis, the court held that the defendants failed to establish the basis for a burden shift.[6] But the court concluded that it would have reached the same view that the transaction was not entirely fair regardless of which party bore the burden of persuasion since the standard of proof is a preponderance of the evidence and the court was not "stuck in equipoise" on the issue of fairness in this case.[7]

- Because the court's entire fairness analysis identified numerous deficiencies in the negotiation process, the court found that the Special Committee was not well functioning.[8]
- Chancellor Strine expressed some reservation that the development of the entire fairness persuasion shifting precedent is such that the determination of which party bears the burden of persuasion cannot occur prior to a full examination of the facts, forcing the parties (and jurist) to litigate without knowing who bears the burden. However, he opined that the determination will be unimportant to the outcome in all but the closest cases.[9] While that may be true in many cases, practitioners generally believe that there is a litigation advantage to having the other party bear the burden.
- The court also observed that, under Delaware law, approval of the transaction by a majority of the stockholders not affiliated with the controlling stockholder only shifts the burden of persuasion if the transaction is conditioned upon such approval, which was not the case in *Southern Peru*.[10]
- Additionally, the court found that the vote of the Southern Peru shareholders had not been fully informed because of several defects in the proxy statement; most significantly, the failure to disclose a counteroffer made by the Special Committee in the early stages of the negotiation with a market value $1 billion lower than the final price.[11] The court also found that Grupo Mexico had presented misleading information in its post-signing road show.[12]

B. APPLICATION OF ENTIRE FAIRNESS ANALYSIS

Entire fairness review entails an integrated analysis of whether both the price and process were fair to the controlled company.[13] In the *Southern Peru* decision, the court found that both the price paid and the process undertaken were unfair.

- The Special Committee "extracted a narrow mandate" to "evaluate" the proposed transaction; the authorizing resolutions were silent regarding the Special Committee's power to negotiate with Grupo Mexico or to consider alternative transactions or structures. The court found that this limited mandate "stilted" the negotiations by engendering a "controlled mindset" by the Special Committee under which the Committee focused exclusively upon "finding a way to get the terms . . . proposed by Grupo

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5 *Id*. at 56.

6 *Id*. at 56. [If a defendant establishes a burden shift, the plaintiff must "prove unfairness under a preponderance standard." *Id*. at 54.]

7 *Id*. at 62.

8 *Id*. at 56.

9 *Id*. at 49-56.

10 *Id*. at 56-58.

11 *Id*. at 58-59.

12 *Id*. at 62.

13 *Weinberger* v. *UOP, Inc*., 457 A.2d 701 (Del. 1983); *Tremont*, 694 A.2d at 428.

Mexico to make sense."[14] The court further noted that without a mandate to explore options other than the transaction proposed by the controlling shareholder in a circumstance where the controlling shareholder was the seller of the assets, the Special Committee lacked "leverage to extract benefits for the minority."[15] The court highlighted the emphasis precedent cases place on the ability of a special committee to "exercise real bargaining power" in a process "as though each of the contending parties had in fact exerted its bargaining power at arm's length."[16]

- One of the four Special Committee members and chief negotiators, Handelsman, was employed by the owner of Cerro. Coincident with the transaction negotiations, Cerro and Phelps Dodge were seeking registration rights for their shares so they would be freely transferable under U.S. securities laws. The court found problematic the fact that Cerro was looking to exit the stock at the same time that the Special Committee, including Handelsman, was charged with advancing the interests of long-term Southern Peru shareholders. Handelsman did not participate in the final Special Committee vote to approve the transaction, but the Court found his recusal from voting did not mitigate the effect of his full participation in Special Committee deliberations prior to that vote. Although the court found no evidence that Handelsman acted in bad faith, the court clearly considered Handelsman's position as one of a number of contributing bad facts to an overall bad pattern.[17] Handelsman's position was not identified as a conflict to Handelsman or the Special Committee until the day the Special Committee approved the agreement, and highlights the importance of carefully identifying all possible conflicts early in any transaction.
- In considering the fairness of the price, the court was critical of what it characterized as the Special Committee's "altered state of a controlled mindset" that hemmed in its evaluation and negotiation of the transaction proposed by Grupo Mexico.[18] The court observed that throughout its deliberations, the Special Committee focused on ways to get the Grupo Mexico transaction to make sense "rather than aggressively testing the proposition that the transaction was a good idea in the first place."[19]
    - The court observed that when preliminary standalone values of Minera prepared by the Special Committee's financial advisor produced values of no more than \$1.4 to \$1.7 billion, the Special Committee should have pushed Grupo Mexico to accept a purchase price near that standalone value rather than rapidly abandon that analysis in favor of a consideration of the relative values of Minera and Southern Peru based on relative discounted cash flow valuation analyses.[20]
    - The court was critical of numerous specific decisions embedded in the valuation analyses performed, including the application of selected EBITDA multiples for Southern Peru to Minera, and the "optimization" of Minera financial projections without any comparable updating of Southern Peru's projections.[21]
    - The court also criticized the Special Committee's willingness to accept that the value of Southern Peru was less than its share trading price would imply.[22] According to the court, a reasonable third-party buyer would only go beyond the market price of its own acquisition currency where it believed the fundamentals would support a <u>higher</u>, not lower, valuation. The court rejected as "an after-the-fact rationalization conceived of for litigation purposes"

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14 *Southern Peru*, at 63-70.

15 *Id*. at 69.

16 *Id*. at 50 and n.86 (quoting *Lynch*, 638 A.2d at 1121).

17 *Id*. at 29-34.

18 *Id*. at 64.

19 *Id*. at 70.

20 *Id*. at 70-72.

21 *Id*. at 72-76.

22 *Id*. at 76-78.

the defendants' argument that the price paid for Minera in the transaction was justified by the Special Committee's secret belief that long-term copper prices would be significantly higher than the price assumed by the financial advisor in its valuation analyses. The court also found the position at odds with the Special Committee's decision to employ a fixed exchange ratio.[23]

- The court dismissed as insignificant certain deal terms the defendants pointed to that were added to the final agreement as a result of negotiations between Grupo Mexico and the Special Committee—including a reduction in Minera's net debt, a $100 million dividend paid out by Southern Peru at closing, changes in corporate governance at Southern Peru, the two-thirds supermajority vote and the fixed exchange ratio.[24] The court noted that Minera was already contractually obligated to pay down its debt and many of the corporate governance changes were suggested by Grupo Mexico. The court was nonplussed by the Special Committee having given up its attempt to condition the merger on obtaining the approval of a majority of the unaffiliated minority in favor of a two-thirds majority, when it knew that Cerro was obligated to withdraw its support for the transaction if the Special Committee withdrew its recommendation, Phelps Dodge likely would support the transaction to gain registration rights and the vote of Grupo Mexico and one of either Cerro or Phelps Dodge was sufficient to achieve the two-thirds vote.[25] The court, seemingly influenced by the fact that the Southern Peru share price increased considerably after the transaction was agreed, also was unimpressed by the defendants' argument that the Special Committee considered it a victory to strike a deal for a fixed number of Southern Peru shares (rather than a fixed dollar price and floating number of shares).[26]

- The court was particularly troubled by the Special Committee's failure to use the one lever it did have—the ability to change its recommendation and the effect that would have had on the stockholder vote. Between signing the merger agreement and the shareholder meeting to approve the merger, Southern Peru significantly outperformed its financial projections and the market value of Southern Peru common shares (and the purchase price) significantly increased. Even though Cerro would be required to vote against the transaction if the Special Committee changed its recommendation, the Special Committee nevertheless never reevaluated its recommendation or sought a bring-down fairness opinion from its financial advisor, which the court described as "a regrettable and important lapse."[27] While the court's observations are consistent with current law and practice regarding directors' obligations, the *Southern Peru* decision may lead to an increased focus on the need for bring-down fairness opinions or advice from a financial advisor in situations where there has been a change in circumstances.

C. DAMAGES

The court awarded damages of $1.263 billion plus interest, an amount equal to the difference between the "fair value of Minera" at the signing date and the actual purchase price.[28] The court determined fair value by averaging the values resulting from (1) a discounted cash flow analysis of Minera, (2) the market value at signing of the Special Committee's counteroffer to Grupo Mexico in the early stages of the

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[23] *Id*. at 79-85.

[24] *Id*. at 85-86.

[25] *Id*.

[26] *Id*. at 87-88.

[27] *Id*. at 88-93.

[28] *Id*. at 97-98, 104.

negotiation and (3) a comparable companies analysis of Minera.[29] The court's inclusion of the value of a negotiation counteroffer (according it 33% weight) in the determination of "fair value" is surprising because such negotiating positions generally have not been relied on by courts so as not to inhibit a special committee from being aggressive in its negotiating posture with the controlling shareholder.

D. TAKEAWAYS

Chancellor Strine generally intends for his opinions to provide guidance to practitioners and parties in future transactions. *Southern Peru* does not break substantial new ground, but it provides a host of important reminders for parties considering a controlled company transaction:

- Entire fairness is an extremely rigorous, exacting form of judicial review in which a jurist effectively second-guesses every business decision of a board of directors, a special committee and their advisors with respect to a particular transaction.
- Surviving an entire fairness review requires a special committee to employ and document meticulous attention to the process it follows. The record of the Southern Peru Special Committee's reasoning does not appear to have been well developed; minutes of many meetings were not available to the court.
- A well-functioning special committee requires that the controlling shareholder accept that the special committee and its advisors should negotiate strongly for the best possible transaction for the minority—that by doing so the special committee is doing its duty <u>and</u> helping to assure that the controlling shareholder will not face a large post-closing judgment.
- Boards should be judicious in determining the scope of the resolutions establishing a special committee's mandate. While board resolutions often limit the ability of special committees to investigate alternative transactions in light of the controlling shareholder's expressed disinclination to permit them, care should be taken that the particular facts of the case warrant such an approach. In any event, the controlling shareholder should give the special committee (and the special committee should seek) explicit authority to negotiate and either recommend against or say no to the controller's proposed transaction.
- Boards and special committees should be mindful in all transactions, but particularly in transactions that may be subject to entire fairness review, of the importance of considering the advisability of their recommendation to shareholders both as of the date of mailing the definitive proxy or other disclosure document and the date of the shareholders meeting, in light of any materially changed circumstances.
- Boards should ensure that their inquiry into the disinterestedness of members of a special committee is sufficiently broad to capture any potential conflicts.

[29] Id. at 99-104.

- Because of the breadth of topics touched on by *Southern Peru* and the court's dissatisfaction with many of the decisions made by the Southern Peru Special Committee, the court's criticism of certain matters mistakenly could be viewed as applicable in all circumstances. In particular, we believe (i) the court's critique of the Special Committee's give (Southern Peru shares)-get (Minera shares intrinsic value) analysis is an admonition against special committees using valuation techniques that are not supported by informed and thoughtful business analyses rather than a general indictment of a well-supported and frequently utilized give-get valuation, (ii) the court's criticism of the fixed exchange ratio should not be read as a general indictment of fixed exchange ratios, which in many cases represent the appropriate business judgment of a board or committee, and (iii) the court's heavy weighting of a negotiating counteroffer in its damages assessment is likely limited to the particular fact pattern present in *Southern Peru*.

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