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Delaware Court Awards $1.26 Billion in Damages in Entire Fairness Case

The Delaware Court of Chancery recently awarded $1.26 billion in damages in *In re Southern Peru Copper Corp. S'holder Deriv. Litig.* after finding that a transaction between a corporation and its controlling stockholder was unfair. This award, which was rendered by Chancellor Leo E. Strine, Jr., is reportedly the second-largest derivative award in the court's history. The decision is an important reminder of the risks associated with conflict of interest transactions, the importance of appropriate process by boards and special committees when faced with conflicts, and the necessity to properly constitute the special committee with sufficient authority to address those conflicts.

Background

In early 2004, the controlling stockholder of Southern Peru Copper Corporation, a Delaware corporation listed on the New York Stock Exchange (the "Company"), proposed selling its 99.15% stake in a privately-held mining business ("Minera") to the Company. The controlling stockholder's proposal valued Minera at more than $3 billion and contemplated the issuance of new common stock by the Company as consideration for the sale. The Company formed a special committee composed of directors who were not affiliated with the controlling stockholder to "evaluate" the transaction. The special committee also hired its own legal and financial advisors. The court noted, however, that the committee's authority was "narrow" and that there was uncertainty among its members about the extent of the committee's mandate.

As detailed in the opinion, the special committee struggled to justify the controlling stockholder's proposed price for the transaction. For example, a discounted cashflow analysis yielded an implied value of approximately $1.1 billion less than the controlling stockholder's proposed valuation. Rather than negotiate for a lower price, however, the court found that the special committee and its financial advisors "began to embrace the idea that" the Company and Minera should be "valued on a relative basis" and that the publicly-traded shares of the Company that would be issued in the transaction should be analyzed for their intrinsic value rather than their market value. The court found that the special committee had worked "backwards to accommodate [the controlling stockholder's] asking price—an asking price *that never really changed*" and that ultimately was approved.

Implications

The 105-page opinion is instructive on numerous topics involving the transaction and the special committee's role.

- *Controlling Stockholder Transactions*. Delaware courts continue to scrutinize controlling stockholder transactions. Recent Delaware cases have suggested lowering the standard of review from entire fairness to the deferential business judgment rule when a controlling stockholder transaction is approved by a special committee and a majority of the outstanding minority shares. In the absence of those procedural devices, however, the courts will scrutinize the transaction for "fair price" and "fair dealing."

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- *Special Committee's Mandate*. The court was critical of the special committee's mandate only to "evaluate" the transaction at issue. There was no record of the special committee considering other options, including a potential sale of the Company to the controlling stockholder. As the court explained: "Rather than tell the controller to go mine himself, the special committee and its advisors instead did something that is indicative of the mindset that too often afflicts even good faith fiduciaries trying to address a controller…. the special committee put itself in a world where there was only one strategic option to consider, the one proposed by the controller, and thus entered a dynamic where at best it had two options, either figure out a way to do the deal the controller wanted or say no." This analysis is similar to Vice Chancellor J. Travis Laster's 2010 decision in *In re CNX Gas Corp. S'holders Litig*, in which he pushed for special committees to more fully replicate third-party transactions. As Chancellor Strine stated in *Southern Peru*, "[e]ven if the practical reality is that the controlling stockholder has the power to reject any alternative proposal it does not support, the special committee still benefits from a full exploration of its options."

- *Valuation*. Delaware courts have significant experience in valuation disputes and will closely review a board or special committee's valuation methodologies. Here, the court found that "the special committee and its financial advisor … took strenuous efforts to justify a transaction at the level originally demanded by the controller." It further stated that the special committee and its financial advisor looked to a "non-real world set of analyses" in order to "rationalize" the proposed transaction and that their "focus was on finding a way to get the terms of the … structure … to make sense, rather than aggressively testing the assumption that the merger was a good idea in the first place."

- *Ongoing Duty to Review the Transaction*. The court also faulted the special committee for failing to review its recommendation prior to the stockholder vote. The Company had agreed to a fixed exchange ratio in the transaction and, after signing the merger agreement, the Company's stock price had increased significantly. As a result, the controlling stockholder was receiving a value much greater than what it initially demanded. In those circumstances, the court questioned why the special committee did not reassess the situation, request its financial advisor to update its fairness analysis, and potentially change its recommendation that the Company's stockholders approve the transaction. "To my mind," Chancellor Strine wrote, "an adroit Special Committee would have recognized the need to re-evaluate the Merger in light of Southern Peru's then-current stock price." This was also important because the Company's second-largest stockholder had entered into a voting agreement that, when combined with the controller's voting power, was sufficient to approve the transaction, which was conditioned on two-thirds stockholder approval. That voting agreement required the stockholder to vote against the transaction, however, if the special committee changed its recommendation. This "out" in the voting agreement only had "utility," the court explained, "if the Special Committee seriously considered the events between the time of signing and the stockholder vote and made a renewed determination of whether the deal was fair."

- *Constituency Directors*. The decision also reveals potential pitfalls for special committee members who are affiliated with other stockholders. During the special committee's negotiations with the controlling stockholder, the Company's second-largest stockholder was holding separate discussions with the controller to obtain registration rights for its shares of the Company. That stockholder's board representative, however, was also on the special committee. The court was critical of this potential conflict, although it concluded that the director did not act in bad faith. Chancellor Strine stated that "there is little doubt in my mind that [the second-largest stockholder's] own predicament as a stockholder dependent on [the controlling stockholder's] whim as a controller for registration rights influenced how [its designee who served on the special committee] approached the situation. That does not mean he consciously gave in, but it does mean that he was less than ideally situated to press hard."

- *Burden Shifting by Special Committee*. The court confirmed that, under the Delaware Supreme Court's decision in *Kahn v. Tremont*, 649 A.2d 422 (Del. 1997), the use of a special committee will shift the burden of proving a transaction was unfair to the plaintiff, but only if the special committee was "independent" and "well functioning." Under the facts found at trial, however, the court concluded that the burden did not shift because the special committee was not "well functioning" primarily because of its narrow mandate and that it was "trapped in the controlled mindset, where the only options to be considered are those proposed by the controlling stockholder."

- *Burden Shifting by Minority Stockholder Approval*. The court also confirmed several prior Delaware decisions holding that a non-waivable majority-of-the-minority stockholder approval condition will shift the burden of proof to the plaintiff. The court emphasized that such an approval requirement must be "conditioned up-front" in order to empower the minority stockholders. Applying this law to the facts, the court held that a requirement that the transaction be approved by two-thirds of the Company's stockholders did not shift the burden to the plaintiff which could be satisfied by the vote of the controlling stockholder plus either of the Company's next two largest stockholders. The court also held that the stockholder vote was not fully informed due to certain omissions in the Company's proxy statement.

- *Damages*. Finally, *Southern Peru* reveals the broad equitable powers of the Court of Chancery. The court decided not to grant rescissory damages due in part to the plaintiff's delay in pursuing the litigation. Instead, the court awarded the difference between "the price that the Special Committee would have approved had the Merger been entirely fair" and the market value of the stock issued to the controlling stockholder as of the closing date, which came to $1.263 billion, plus interest. The court held that the award could be satisfied by the controlling stockholder's return of the number of shares necessary to satisfy the judgment.

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