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Delaware Chancery Court Holds that Controlling Shareholder Transaction Fails Entire Fairness Review; Awards $1.263 Billion in Damages

In the recent *In re Southern Peru Copper Corp. Derivative Litigation, C.A. No. 961-CS (Del. Ch. Oct. 14, 2011)* decision, the Delaware Court of Chancery (Chancellor Strine) awarded $1.263 billion in damages (plus interest from the merger date to judgment and payment) after finding that the acquisition of Minera Mexico, S.A. de C.V. by Southern Peru Copper Corporation in a controlling stockholder transaction failed to satisfy the entire fairness standard of review. The damages award reflects the Court's approximation of the difference between the price that would have been paid in the transaction if it had been entirely fair and the actual price that was agreed to be paid in the transaction.

The case involved the acquisition of privately held Minera Mexico by Southern Peru, an NYSE listed company. Both Southern Peru and Minera Mexico were controlled by the same large stockholder, Grupo Mexico, S.A.B. de C.V. (which held 54.17% of the capital stock and 63.08% of the vote of Southern Peru and 99.15% of Minera Mexico). Southern Peru appointed a Special Committee consisting of four directors to evaluate a proposal made by Grupo Mexico that Minera be acquired by Southern Peru. The Special Committee retained financial and legal advisors and took part in discussions that culminated in a stock-for-stock merger transaction that was approved by the Special Committee, the board of directors of Southern Peru and eventually the holders of more than 90% of Southern Peru's common stock.

Nonetheless, the Court found that the transaction failed to satisfy the entire fairness standard of review and noted the following:

- *Burden of Proof.* While a defendant may shift the burden of persuasion on entire fairness to the plaintiff based on the existence of the approval of a Special Committee of disinterested directors, under prevailing Delaware precedent for the burden to shift the Special Committee must function in a manner that indicates that the controlling stockholder did not dictate the terms of the transaction and that the committee exercised real bargaining power at arms-length. This requires an examination of the actual effectiveness of the Special Committee, an inquiry that centers in part on whether the Special Committee "simulated the role a third-party with negotiating power would have played." The Court concluded that the burden of persuasion remained with the defendants because the committee did not effectively play such role and accordingly was not well functioning. Additionally, the Court dismissed the defendants' contention that the burden should shift based on the fact that the merger was, in fact, eventually approved by a majority of the disinterested stockholders because the transaction was not conditioned up-front on their approval. (Interestingly the Court did note that the benefits of a burden shift are slight and would not have altered the outcome in this case).

- *Special Committee Mandate.* The Court was critical of the narrow mandate granted the Special Committee, namely to "evaluate" a transaction suggested by a majority stockholder. It noted that such a narrow mandate "trapped [the Special Committee] in a controlled mindset, where the only options to be considered are those proposed by the controlling stockholder" and that "[e]ven if the practical reality is that the controlling stockholder has the power to reject any alternate proposal it does not support, the Special Committee benefits from a full exploration of its options." Notably, the Court concluded that the Special Committee's acceptance of its narrow mandate (i.e., its failure to obtain the authority to permit it to act like a third party negotiator with the full availability of alternatives) "influences my ultimate determination of fairness . . . ."

- *Effects of a "Controlled Mindset".* The Court noted that the "controlled mindset" of the Special Committee was illustrated by how the discussions unfolded. Grupo Mexico had initially proposed an asking price of $3.147 billion to be paid in shares of Southern Peru's publicly-traded stock valued at their then current trading price for its stake in Minera that was valued on a standalone basis by the Special Committee's financial adviser in a range of between $1.1 and $1.7 billion. The Court found that the Special Committee began to employ a series of valuation methodologies that improperly devalued the share consideration to be paid by Southern Peru (even though the Special Committee acknowledged that the share consideration if sold in the market could yield in cash its trading price), on the one hand, and enhanced the value of the Minera equity stake, on the other hand, in order to bridge the substantial valuation gap. The Court found that the valuation methodology employed by the Special Committee and its advisers was results oriented and "undermine[s] defendants' argument that the process was fair and lend[s] credence to the plaintiff's contention that the process leading up to the Merger was an exercise in rationalization."

- *Failure to Update Fairness Analysis.* The Court was critical of the fact that the Special Committee did not update its fairness analysis prior to closing of the merger in the face of strong evidence that the bases for its decision had changed. The merger transaction was subject to a Southern Peru stockholders' vote and the Special Committee had negotiated for the freedom to change its recommendation in favor of the merger if its fiduciary duties so required. In particular, the Court noted that (1) five months elapsed between signing and the stockholder vote, (2) during that period Southern Peru's stock price was steadily rising but the merger consideration was determined on a fixed ratio basis without a collar (resulting in a higher effective price being paid by Southern Peru), (3) during that period Southern Peru's performance had greatly exceeded its projections while Minera's performance had lagged its projections and (4) a large stockholder of Southern Peru had entered into a voting agreement with Grupo Mexico that obligated the holder to vote for the merger unless the Special Committee withdrew its recommendation (and that holder's vote, together with Grupo Mexico's vote, was sufficient to approve the merger).

Based on the foregoing, the Court concluded that the transaction was unfair regardless of which party bore the burden of persuasion and as a result that the defendants had breached their fiduciary duty of loyalty.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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