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Expert Analysis

Special Committee Loses Perspective in Making Deal with Controlling Stockholder

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The Delaware Chancery Court recently raised the bar for special committees and their advisers in the context of a controlling stockholder transaction.

In *In re Southern Peru Copper Corp. Shareholder Derivative Litigation*, Chancellor Leo Strine held that a special committee comprised of independent and well-meaning directors, with top-flight advisers (Goldman Sachs and Latham & Watkins), became trapped in a "controlled mindset" and allowed the controller to dictate the terms and structure of a conflict transaction.[1] When confronted with a less than desirable proposal, "[r]ather than tell the controller to go mine himself, the special committee and its advisers instead did something that is indicative of the mindset that too often afflicts even good-faith fiduciaries trying to address a controller."[2]

"[T]he 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 into a dynamic where at best it had two options, either figure out a way to do the deal the controller wanted or say no."[3] In the end, "after a bunch of back and forth" the committee found a way to give the controlling stockholder "what it originally demanded."[4]

THE SPECIAL COMMITTEE'S JOB

Distilled to its essence, *Southern Peru* stands for the premise that the special committee's job is to determine whether the controller's proposed transaction would be the best strategic alternative for the minority stockholders, rather than the more comfortable questions of whether the controller's proposal is fair and can be justified.

Southern Peru Copper Corp., a New York Stock Exchange-listed company, operates mining, smelting and refining facilities in Peru, producing copper and molybdenum, as well as other metals.

Grupo Mexico, a Mexican holding company, owned 54 percent of Southern Peru's stock and also owned another mining company, Minera Mexico. Cerro Trading Co., which is owned by the Pritzker family, and Phelps Dodge Corp. each owned 14 percent

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of Southern Peru. In an interesting twist, both of these large stockholders wanted to monetize their stock and exit the investment. They needed Grupo Mexico's cooperation to register their Southern Peru shares for a secondary stock offering. Therefore, the two other large stockholders were beholden to the controller and their economic interests were not aligned with the interest of the minority, public stockholders. To help avoid the conflict, Cerro signed a voting agreement requiring it to vote in accordance with the special committee's recommendations.

Grupo Mexico approached Southern Peru's independent directors and proposed that the company buy the non-publicly traded Minera Mexico (the mining company owned by Grupo Mexico) for $3.1 billion of Southern Peru's NYSE-listed stock. An important distinction between the two companies was that Minera had substantial financial difficulties and its ability to exploit its assets had been compromised by financial constraints. By contrast, Southern Peru was in good financial condition and virtually debt-free.

"The special committee did not respond to its intuition that Southern Peru was over-valued in a way consistent with its fiduciary duties or the way that a third-party buyer would have," Chancellor Leo Strine said.

THE EVALUATORS

The Southern Peru board established a special committee to "evaluate" the proposal. The committee was comprised of three experienced and well-trained businessmen, who were all nominated to the board by Grupo Mexico. A fourth director, Harold Handelsman, a former Wachtell Lipton M&A attorney who worked for the Pritzker family, was also on the committee.

The special committee engaged Goldman Sachs as its financial adviser and Latham & Watkins as its legal counsel, as well as technical mining consultants.

Goldman's analysis valued Minera Mexico at about $2 billion based on discounted cash flow and other stand-alone valuation measures. Therefore, from Chancellor Strine's perspective, the "give" (the cash value of Southern Peru's NYSE-listed stock) was more than $1 billion greater than the "get" (the value of the non-publicly traded Mexican mining company).

The special committee got "lost in the perspective-distorting world of dealmaking with a controlling stockholder," according to Chancellor Strine.[5] In order to get "comfortable" with the fairness of Grupo Mexico's proposal, the special committee and Goldman abandoned focus on the fact that Southern Peru could get $3.1 billion in value in the exchange for its NYSE-listed stock and embarked on a "relative valuation" approach. That approach was based on the conclusion that Southern Peru's stock was "over-valued" and had "fundamental value less than its stock market trading price." The committee "assured itself that a deal could be fair so long as the 'relative value' of the two companies was measured on the same metrics."[6]

'COMMERCIAL CHARITY'

The special committee should have responded by "suggesting that the controller make an offer for the NYSE-listed company at a premium to what the special committee apparently viewed as a plush market price, or making the controller do a deal based on the Mexican company's standalone value."[7] Instead, "the special committee and its financial adviser ... took strenuous efforts to justify a transaction at the level originally demanded by the controller."[8]

Chancellor Strine concluded that the special committee's "non-adroit act of commercial charity toward the controller resulted in a manifestly unfair transaction" and awarded the plaintiff a $1.26 billion judgment.

Under *Kahn v. Tremont*, where the controlling stockholder stands on both sides of the transaction, the interested defendants are "required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain."[9]

However, the *Lynch* doctrine provides "when the entire-fairness standard applies, controlling stockholders can never escape entire-fairness review, but they may shift the burden of persuasion by one of two means: They may show that the transaction was approved either by an independent board majority (or in the alternative, a special committee of independent directors) or, assuming certain conditions, by an informed vote of a majority of the minority stockholders."[10]

Relying on *Tremont*, Chancellor Strine ruled that the special committee must "function in a manner which indicates that the controlling shareholder did not dictate the terms of the transaction and the committee exercised real bargaining power 'at an arm's length.'"[11] Chancellor Strine held that "the inquiry must focus on how the special committee actually negotiated the deal — was it 'well functioning' — rather than just how the committee was set up. The test, therefore, seems to contemplate a look back at the substance and efficacy, of the special committee's negotiations, rather than just a look at the composition and mandate of the special committee."[12]

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At its essence, in order for the special committee to merit a burden shift, the question is "whether the special committee in fact simulated the role that a third party with negotiating power would have played. … [T]here is no way to decide whether the defendant is entitled to a burden shift without taking into consideration the substantive decisions of the special committee, an exercise that overlaps with the examination of fairness itself."[13]

Southern Peru offers several important lessons for special committees and their advisers in the context of a controlling stockholder transaction. The first lesson is that the authorizing resolution should expressly and unequivocally empower the special

Lessons from Southern Peru

The authorizing resolution should expressly and unequivocally empower the special committee to negotiate with the controller and to consider other strategic alternatives.

The special committee should stay focused on the "give/get" analysis in real cash terms; value the company's publicly traded stock at its market trading price and value the controller's proposed merger partner using a stand-alone valuation.

The committee should consider getting an updated fairness opinion immediately before the stockholder meeting.

committee to negotiate with the controller and to consider other strategic alternatives. One of the fundamental flaws in the Southern Peru deal was the special committee's narrow mandate to "evaluate" a transaction suggested by the majority stockholder rather than being actually empowered to negotiate.[14] The special committee "did not insist on the right to look at alternatives; rather, it accepted that only one type of transaction was on the table, a purchase of Minera by Southern Peru."[15]

Chancellor Strine concluded that excluding the ability to explore other options "deprived the special committee of negotiating leverage to extract better terms."[16] The special committee's "controlled mindset" that it only can evaluate the transaction suggested by the majority stockholder puts the special committee at a disadvantage. It did not consider the other options for which the company could deploy its capital to determine whether better alternatives were available than the transaction proposed to the special committee.

Moreover, according to Chancellor Strine, "the very process of the special committee asking the controlling stockholder to consider alternative options can change the negotiating dynamic. That is, when the special committee engages in a meaningful back-and-forth with the controlling stockholder to discuss the feasibility of alternate terms, the special committee might discover certain weaknesses of the controlling stockholder, thus creating an opportunity for the committee to use this new-found negotiating leverage to extract benefits for the minority."[17]

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ALTERNATIVES OFFERED

In this case, if Grupo Mexico had been open to a special committee proposal that it buy out Southern Peru's other stockholders at a premium to its rising stock price, this would have provided the Southern Peru stockholders an opportunity to obtain liquidity at a premium to Southern Peru's market price. The special committee had already identified that as being high in comparison to Southern Peru's fundamental value. "Throughout the negotiation process, the special committee's and Goldman's focus was on finding a way to get the terms of the merger structure proposed by Grupo Mexico to make sense, rather than aggressively testing the assumption the merger was a good idea in the first place."[18]

Southern Peru's second lesson is that the committee should stay focused on the "give/get" analysis in real cash terms and value the company's publicly traded stock at its market trading price, at least when favorable to the company, and to value the controller's proposed merger partner using a stand-alone valuation without the benefit of synergies from the proposed deal.

When Goldman first identified that the value of the "get" (Minera) was nowhere near the "give" (Grupo Mexico's asking price of $3.1 billion), Goldman and the special committee should have pushed back with a strong response. Instead, Goldman and the committee went to strenuous lengths to equalize the values and attempt to make the transaction make economic sense and to rationalize paying Grupo Mexico's asking price. Chancellor Strine found that rather than "blithely" moving on to the relative value analysis, the special committee should have had a "continuing and relentless focus on the actual give-get involved in real cash terms."[19]

FAILING TO PUSH BACK

However, because of a "controlled mindset," the special committee failed to push Grupo Mexico into the range suggested by Goldman's analysis of fundamental value, and instead went backward to accommodate Grupo Mexico's asking price.

Chancellor Strine was also critical that the special committee "ignored a fundamental economic fact that is not in dispute here — … Southern Peru's stock could have been sold for a price at which it was trading on the New York Stock Exchange."[20]

Chancellor Strine acknowledged that under Delaware law, fair value can be determined "by any techniques or methods which are generally considered acceptable in the financial community" and "it is not a breach of faith for directors to determine that the present stock market price of shares is not representative of true value or that there may indeed be several market values for any corporation's stock."[21]

A key point in this case, however, as Chancellor Strine noted, was "the special committee did not believe that Southern Peru was being under-valued by the stock market. To the contrary, its financial adviser Goldman, after months of study, rendered analyses suggesting that Southern Peru was being over-valued by the market."[22]

In other words, "the special committee did not respond to its intuition that Southern Peru was over-valued in a way consistent with its fiduciary duties or the way that a third-party buyer would have."[23] "Put bluntly, a reasonable third-party buyer would only go behind the market if it thought the fundamental values were on its side, not retreat from a focus on market if such a move disadvantaged it. If the fundamentals were on Southern Peru's side of this case, the DCF [discounted cash value] value of Minera would have equaled or exceeded Southern Peru's give. But Goldman and the special committee could not generate any responsible estimate of the value of Minera that approached the value of what Southern Peru was being asked to hand over."[24]

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The special committee should have insisted on a "majority of the minority" vote requirement rather than settling for a two-thirds supermajority stockholder vote requirement. The special committee knew that the Cerro Trading and Phelps Dodge wanted to sell and that along with Grupo Mexico, these large holders would guarantee the vote as together the three owned 82 percent of Southern Peru.

During the five months between the signing of the merger agreement and the stockholders' vote, Southern Peru's financial performance substantially exceeded its projections and its stock price had steadily risen. The terms of the Grupo Mexico deal had no collar, but instead were a fixed share-for-share exchange ratio. Chancellor Strine concluded that the special committee's "controlled mindset" caused it to not consider renegotiating or re-evaluating the merger based on these changes.[25]

LAST LESSON

The final lesson of *Southern Peru* is that the special committee should at least consider getting an updated fairness opinion immediately before the stockholder meeting. Chancellor Strine found the special committee's failure to get a fairness opinion update "even more of a concern because Cerro had agreed to vote against the merger if the special committee changed its recommendation."[26] "This out was only meaningful, however, if the special committee took the recommendation process seriously. If the special committee maintained its recommendation, Cerro had to vote for the merger, and its vote combined with Grupo Mexico's vote would ensure passage."

Given these flaws in the process, the special committee was not "well functioning" and therefore under *Lynch* and *Tremont*, the burden of persuasion remained with the controlling stockholder.[27] Chancellor Strine found that "[a]fter this game of controlled-mindset Twister and the contortions it involved, the special committee agreed to give away over $3 billion worth of actual cash value in exchange for something worth demonstrably less, and to do so on terms that by consummation made the value gap even worse, without using any of its contractual leverage to stop the deal or renegotiate its terms. Because the deal was unfair, the defendants breached their fiduciary duty of loyalty."[28]

Chancellor Strine based damages on "the price that the special committee *should* have paid. Given the difference between the stand-alone equity values of Minera derived by Goldman and the plaintiff's expert and the actual cash value of the $3.75 billion in Southern Peru stock that was actually paid to Grupo Mexico in the merger, the record could arguably support a damage award of $2 billion or more."[29]

Chancellor Strine, after considering a variety of valuation mechanisms, concluded that the equity value of Minera was $2.4 billion and the value of Southern Peru (market value of the Southern Peru shares on the merger date) was $3.67 billion.

Therefore, the judgment was $1.26 billion. Chancellor Strine permitted Grupo Mexico to satisfy the judgment by agreeing to return to Southern Peru the number of its shares as are necessary to satisfy this remedy.

NOTES

1 *In re Southern Peru Copper Corp. S'holder Derivative Litig.*, 2011 WL 4907799 (Del. Ch. Oct. 14, 2011).

2 *Id.* at *1.

3 *Id.*

4 *Id.* at *2.

5 *Id.* at *26.

6 *Id.* at *1.

7 *Id.*

8 *Id.*

9 *Id.* at *20 (*quoting Weinberger v. UOP Inc.*, 457 A.2d 701, 710 (Del. 1983)).

10 *Id.* (*quoting Kahn v. Lynch Commc'n Sys.*, 638 A.2d 1110, 1117 (Del. 1994)).

11 *Id.* at *21 (*quoting Kahn v. Tremont Corp.*, 694 A.2d 422, 429 (Del. 1997)).

12 *Id.*

13 *Id.* at *22.

14 *Id.* at *26.

15 *Id.*

16 *Id.*

17 *Id.* at *28.

18 *Id.* at *29.

19 *Id.*

20 *Id.* at *32.

[21] *Id.* (*quoting Weinberger,* 457 A.2d at 712-13, and Paramount *Commc'ns v. Time Inc.*, 571 A.2d 1140, 1150 n. 12 (Del. 1989)).

[22] *Id.*

[23] *Id.*

[24] *Id.*

[25] *Id.* at *36.

[26] *Id.* at *18.

[27] *Id.* at *23.

[28] *Id.* at *38.

[29] *Id.* at *41.

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