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DELAWARE SUPREME COURT AFFIRMS $2 BILLION DAMAGES AWARD FOR CONTROLLING STOCKHOLDER TRANSACTION FOUND TO BE UNFAIR

In October 2011, Chancellor Leo Strine of the Delaware Chancery Court awarded more than $1.2 billion in damages and interest to Southern Peru Copper Corp. ("Southern Peru") after determining at trial that in a "manifestly unfair transaction," it had substantially overpaid for a mining company that it bought from its controlling stockholder. With interest accruing from the date of the transaction in 2004, the award grew to more than $2 billion. Chancellor Strine also awarded fees of 15 percent of that amount, or more than $300 million, to the attorneys who had challenged the transaction by bringing a derivative suit on behalf of Southern Peru's stockholders. We reported on the Chancery Court decision in a previous *Commentary* (www.jonesday.com/delaware_court_of_chancery_awards/), highlighting the court's finding that the transaction was fundamentally unfair even though Southern Peru had been represented in the transaction by an independent committee of disinterested directors. We wrote at the time that the case "provides important guidance for special committees in structuring and negotiating transactions with controlling stockholders."

That guidance has now been reinforced by the Delaware Supreme Court, which on August 27, 2012 affirmed the judgment. The Supreme Court agreed with all of the Chancery Court's detailed criticisms of the transaction and affirmed its central finding that despite the presence of a special committee—the independence of which was never challenged—the process by which the transaction was concluded, and the resulting price, were fundamentally unfair. The Supreme Court's decision leaves no doubt that in self-dealing transactions where controlling stockholders are directly negotiating with a special committee, the work of the independent committee will face searching scrutiny from the courts.

Southern Peru was a mining company listed on the New York Stock Exchange. Its controlling shareholder was Grupo México, S.A.B. de C.V. ("Grupo México"),

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a holding company listed on the Mexican stock exchange, which owned 54.17 percent of Southern Peru's outstanding capital stock and could exercise 63.08 percent of its voting power. Grupo México also owned a 99.15 percent stake in a privately held Mexican mining company, Minera México, S.A. de C.V ("Minera").

In February 2004, Grupo México proposed that Southern Peru buy its stake in Minera for more than $3 billion in shares of newly issued Southern Peru stock. Southern Peru formed a four-person special committee of disinterested directors to consider the offer, and the committee retained a financial advisor and legal counsel. The special committee, apparently uncertain about its ability to explore other strategic or financial alternatives, limited itself to negotiating with the controlling shareholder over a transaction that the latter clearly desired.

The special committee's financial advisor initially performed a number of standard analyses of the stand-alone value of Minera (discounted cash flow, contribution analysis, and sum-of-the-parts). This analysis suggested that the value of Minera was $1.7 billion—far less than Grupo México's $3.1 billion asking price.

The financial advisor then changed its valuation metrics in ways that reduced the gap between the "give" and the "get." A member of the Southern Peru special committee testified that he believed that the stock issued by Southern Peru would have been worth $3.19 billion in the open market, and the defendants never challenged that conclusion at trial. Nonetheless, the financial advisor substituted a discounted cash flow analysis using "mid-range" assumptions for the discount rate and the future price of copper, which generated a "fundamental" valuation for the Southern Peru stock of only $2.06 billion. According to one member of the special committee, the committee was "comforted" by the fact that under the revised analysis, the difference between the indicated values of the "give" and the "get" was not as great. The special committee embraced the advisor's revised analyses and negotiated with Minera on that basis. In October 2004, the companies reached a deal by which Southern Peru would issue 67 million of its shares to Grupo México for Minera, representing a value of $3.56 billion.

Following a trial, Chancellor Strine concluded that the merger was unfair to Southern Peru. The Chancellor's detailed findings, which are described more fully in our prior *Commentary*, were affirmed after a thorough review.

The Delaware Supreme Court opinion reinforces and expands upon the Chancery Court's findings, and thus contains important guidance for special committees and their advisors. Most notably:

The Court affirmed that even when a company employs a special committee of disinterested directors to negotiate a transaction with a controlling stockholder, the processes and deliberations of that committee will be subject to searching review. It has long been understood that in self-dealing transactions, where a controlling stockholder stands on both sides of the negotiating table, the applicable standard of judicial review is the "entire fairness" of the deal to minority stockholders. This standard, in turn, has two components: "fair dealing" (the process by which the transaction was initiated, structured, negotiated, and disclosed) and "fair price" (the financial consideration). Prior cases had established that the defendants—the parties supporting the deal—bear the burden of persuading the court of its fairness unless the transaction was approved by a "well-functioning committee of independent directors" or was approved by "an informed vote of a majority of the minority shareholders." Here, the Court clarified that "well-functioning" refers not only to the *composition* of the independent committee, but also to *how effectively it does its job*. The Delaware Supreme Court agreed with the Chancery Court that the special committee members were "competent, well-qualified individuals with business experience," that the committee had been "given the resources to hire outside advisors," and that it had hired "top tier of the market financial and legal counsel." All of this, however, was secondary to the fact that the committee had fallen into a "controlled mindset" in which it limited itself to reacting to a proposal that the controlling shareholder clearly desired, rather than engaging in a thoughtful examination of possible alternative strategies or transactions. The Court reviewed, and endorsed, the Chancery Court's detailed recitation of the many points at which the committee either accepted too readily the suspect analyses proffered by its advisors or failed to approach their task with the mindset of truly

independent thinkers devoted solely to the best interests of the minority stockholders.

The Court downplayed the procedural advantage to be gained by shifting the burden of persuasion in such cases from the controlling stockholder to the plaintiff. Although litigators fight vigorously over which party bears the burden of persuasion in a controlling stockholder transaction, the decision casts considerable doubt on the practical value of a burden shift. The Chancery Court had not decided the issue of which party bore the burden of persuasion until after the close of the trial, reasoning that it could not do so because the relevant facts were "deeply enmeshed" in the ultimate fairness analysis. The Delaware Supreme Court recognized the practical problem that this presents to litigators, but solved it by determining that in future cases, the burden would remain with the controlling stockholder unless the defendants could demonstrate their entitlement to a burden shift based on evidence submitted prior to trial. At the same time, the Court emphasized several times that the procedural benefit of burden-shifting was "modest," and it agreed with Chancellor Strine that in this case, the allocation of the burden would have made no difference. The Court confirmed, however, that irrespective of its impact on shifting the burden of proof, the use of a special committee remains important in a judicial assessment of the fairness of the process followed by the directors. The lesson here is that no matter what procedures they employ, special committee members should not expect to be able to avoid a detailed examination of their actions.

The Court confirmed the interrelatedness of "fair process" and "fair price" in the "entire fairness" analysis. It observed that the "entire fairness" analysis "is not a bifurcated one," concluded that "[a] fair process usually results in a fair price," and left no doubt that it believed that the unfair price in this case resulted from a process that was seriously compromised. It also commended the Chancery Court for examining these issues "in a comprehensive and complete manner," and that in light of its thorough analysis, its "determination of entire fairness must be accorded substantial deference on appeal."

The Court affirmed the finding that the special committee members were shielded from personal liability. In an important victory for directors, the Court affirmed the Chancery Court's dismissal of all claims asserted against the special committee defendants, agreeing that by reason of the "exculpation" provision of Southern Peru's Articles of Incorporation, they were immunized from liability for errors in judgment. Even as it criticized their decisions, the Court agreed that the independent directors had not been shown to have breached a duty of loyalty because they had not favored their personal financial interests over those of the stockholders. The Court made clear, however, that the exculpation provision did not protect directors affiliated with Grupo México, or Grupo México itself, and noted that the non-independent directors had made no effort at trial to show that they had acted in good faith. As a result, "their liability would rise or fall with the issue of fairness."

The Court affirmed the breadth of the Chancery Court's discretion in its award of damages. On appeal, the defendants criticized Chancellor Strine's use of three separate valuation metrics to arrive at a blended figure for the presumptive valuation of Minera, but the Delaware Supreme Court held that the Chancery Court enjoyed broader leeway in fashioning a damages remedy in a breach of duty case than it might have in an appraisal action. The Chancery Court applied an out-of-pocket measure of damages comparing the value of the payment made by Southern Peru to the value of what it received from Grupo México. Because the defendants did not dispute that Southern Peru could receive $3.19 billion for its shares in the open market, the Chancery Court assigned that value to the payment made by Southern Peru. In assessing the value of what was received, the Court relied upon three modes to value the Grupo México stock at the time of the merger. The Court found no error in the Chancery Court's "transparent" analysis of damages.

The Court affirmed the sizeable attorneys' fee award. Despite the defendants' objection that a 15 percent contingent fee award was unwarranted in view of the size of the damages amount, the Delaware Supreme Court held that in "common fund" cases, where the actions of the plaintiffs' counsel result in a monetary award to be shared by members of a class, the amount of the fund created is the single most important factor in determining the fee award. Here, even though the award amounted to more than $300

million—and approximately $35,000 for each hour of attorney time worked—the amount of the award was within the broad discretion of the trial court.

This case provides a powerful reminder that regardless of which party bears the burden of persuasion, Delaware courts will carefully examine the actions of a special committee tasked with negotiating a transaction with a controlling stockholder. Special committee members must keep in mind that their ultimate goal is to serve the best interests of the minority shareholders, not merely to "rationalize doing a deal of the kind that the majority stockholder proposed."

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