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Revisiting the Special Committee Process: 'In re Southern Peru Copper Corporation'

BY JOHN MARK ZEBERKIEWICZ

The Delaware Court of Chancery's post-trial opinion in *In re Southern Peru Copper Corporation* [1] is perhaps most notable for the staggering damages award—$1.263 billion—against the controlling stockholder defendants for breach of the duty of loyalty in a transaction subject to entire fairness review. Although the court had dismissed the members of the special committee at an earlier stage of the proceedings, the opinion contains important guidance for special committees considering a controlling stockholder transaction.

Background

In 2004, Southern Peru Copper Corporation (''Southern Peru'') was approached by its controlling stockholder, Grupo Mexico, S.A.B. de C.V. (''Grupo Mexico''), with a proposal to acquire Grupo Mexico's 99.15 percent interest in Minera Mexico, S.A. de C.V. (''Minera'') for approximately $3.1 billion in Southern Peru's NYSE-listed stock. After receiving the proposal, Southern Peru's board of directors formed a special committee, the '' 'duty and sole purpose' '' of which was '' 'to evaluate the [Minera acquisition] in such manner as the Special Committee deems to be desirable and in the best interests of the stockholders of [Southern Peru].' '' [2] As the court noted, the special committee was not expressly authorized to explore other strategic alternatives.[3] After its formation, the special committee engaged well-respected legal and financial advisors as well as a mining consultant to assist with technical aspects of the mining valuation.

According to the court, Grupo Mexico's initial term sheet made clear that it expected to receive approximately $3.1 billion in ''market-tested Southern Peru stock'' for its interests in Minera.[4] At the outset, the special committee's financial advisor conducted various analyses that were summarized in an ''Illustrative Give/Get Analysis'' showing that Southern Peru would contribute shares of its stock with a market value of $3.1 billion in exchange for an asset worth no more than $1.7 billion.[5] After the initial ''give/get'' analysis yielded a wide disparity in consideration, the special committee's financial advisor prepared an analysis showing that Southern Peru's stock was overvalued in the market and that its ''intrinsic'' or ''fundamental'' value was closer to $2.06 billion. Following its receipt of this analysis, the special committee submitted a counterproposal contemplating an acquisition of Minera for 52 million shares of Southern Peru having a then-current market value of approximately $2.095 billion.

After a series of negotiations—including over the stockholder vote that would be required to approve

[1] — A.3d —, C.A. No. 961-CS, 2011 WL 4907799 (Del. Ch. Oct. 14, 2011).

[2] *Id.* at *5.
[3] *Id.*
[4] *Id.* at *6.

[5] In reviewing the initial analysis, the court stated: ''The important assumption reflected in [the financial advisor's] June 11 presentation that a bloc of shares of Southern Peru could yield a cash value equal to Southern Peru's actual stock market price and was thus worth its market value is worth pausing over. At trial, the defendants disclaimed any reliance upon a claim that Southern Peru's stock market price was not a reliable indication of the cash value that a very large bloc of shares—such as the 67.2 million paid to Grupo Mexico—could yield in the market. Thus, the price of the 'give' was always easy to discern.'' *Id.* at *8 (footnotes omitted).

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the transaction, whether the fixed exchange ratio would have a ''collar,'' and whether the special committee would be entitled to terminate the transaction—the parties reached terms on an agreement that would result in Southern Peru issuing 67.2 million shares (with a value of approximately $3.1 billion) for Minera in a stock-for-stock merger. Under the terms of the proposed merger agreement, the special committee would be empowered to change its recommendation, but it could not terminate the deal. The proposed merger agreement did not contain a majority-of-the-minority approval requirement, but it did contain a provision conditioning authorization of the merger on a two-thirds vote of Southern Peru's outstanding stock. Of Southern Peru's two large stockholders (other than Grupo Mexico), one was required by agreement to vote in line with the special committee's recommendation, while the other was free to vote as it deemed fit.

At the meeting at which the special committee considered whether to recommend the merger, the special committee's financial advisor made a presentation using ''relative'' value metrics reflecting the projected relative contribution to cash flows of the two entities to the combined corporation. On this basis, the financial advisor opined that the transaction was fair from a financial point of view to Southern Peru's stockholders. The special committee then recommended the transaction to the full board, which unanimously approved it. Following the announcement, the price of Southern Peru stock declined, but in the five months leading up to the closing, the price began to climb, which the court attributed to the general direction of copper prices and Southern Peru's own financial performance.[6] Despite an increase in the stock price of nearly 22 percent since the signing of the merger agreement, the special committee did not ask its financial advisor to update the fairness analysis or otherwise revisit its recommendation.

Plaintiff brought suit shortly after the transaction was announced. The litigation proceeded slowly, and it was not until 2010 that the plaintiff first moved for summary judgment. The defendants cross-moved for summary judgment or, alternatively, to shift the burden of proof to the plaintiff under the entire fairness standard. At the summary judgment hearing, the court dismissed the special committee defendants from the case on the grounds that the plaintiff had failed to demonstrate any non-exculpated breach of the fiduciary duty of loyalty and denied all other motions for summary judgment. The court indicated, however, that its dismissal of the special committee defendants did not reflect its view that the special committee had acted ''adroitly.'' [7] In this regard, the court offered important guidance regarding special committee processes generally.

Special Committee Mandate

Of critical concern to the court was the narrow mandate given to the special committee. From the outset, the special committee's mandate was simply to ''evaluate'' the controlling stockholder's proposal, not to consider alternatives. While the court found that the special committee did engage in negotiations, its approach was ''stifled and influenced by its uncertainty about whether it was actually empowered to negotiate.'' [8] This call for a broader mandate—one that includes the exploration of strategic alternatives—is consistent with recent Delaware case law addressing the role of special committees vis-à-vis controlling stockholders.[9]

In the controlling stockholder setting, the special committee's power to explore alternatives may seem illusory, given the controller's ability to veto most fundamental transactions. But the Delaware courts have not subscribed to the view that special committees are sufficiently armed with veto power alone.[10] Rather, they have suggested that the special committee process should replicate arm's-length, third-party dealing and that the committee should have the power that a board would have to meet that objective.[11] While the Delaware courts have recognized that a special committee cannot force a controlling stockholder to accede to various fundamental transactions, they have indicated that a special committee must be authorized to use the full panoply of corporate powers available to it to fulfill its ''contextualized'' obligation to the minority stockholders.[12]

Vigorous Negotiation

Perhaps more important than a broad mandate is the special committee's understanding of its mandate[13]—and the use of its powers in the course of negotiations. To this end, the *Southern Peru* court identified several areas in which the special committee's use of the power to explore alternatives may have tilted the negotiations in the favor of the minority stockholders. The court seemed to suggest that, rather than aggressively negotiating a more favorable ratio for the benefit of Southern Peru's minority stockholders, the special committee relied too heavily on financial analyses that devalued the Southern Peru stock and thus made the consideration extended by Southern Peru appear more in line with the value of the assets being acquired. This apparent lack of vigorous negotiation, according to the court, resulted principally from the committee's failure to appreciate its role as a negotiating agent and was indicative of an ineffective committee process.[14] As the court noted, ''[h]aving been empowered only to evaluate what the controller put on the table and perceiving that other options were off the menu because of the controller's own objectives, the special committee put itself in a

[6] *Id.* at *17.

[7] *Id.* at *19.

[8] *Id.* at *26.

[9] *See, e.g.,* S. Muoio & Co. LLC v. Hallmark Entm't Inv. Co., C.A. No. 4729-CC, 2011 WL 863007, at *12–13 (Del. Ch. March 9, 2011).

[10] *See, e.g., In re* CNX Gas Corp. S'holders Litig., 4 A.3d 397, 414 (Del. Ch. 2010) (''Given [the controlling stockholder's] position as [such] and the additional rights [it] possessed under its various agreements with [the company], any effort to explore strategic alternatives likely would have been an exercise in futility. But that was a decision for [the committee] and [its] advisors to make. Armed with an appropriate delegation of authority, [the committee] and the creative minds at [its legal and financial advisors] might have devised ways to increase the Special Committee's leverage.'').

[11] *See id.* at 415.

[12] *See id.* For example, the prospect that a special committee could adopt a rights plan to block the controller ''may be sufficient to prompt a controller to give a special committee more time to negotiate or to evaluate how to proceed.'' *Id.* ''What matters,'' according to the court, ''is that the special committee fulfills its contextualized duty to obtain the best transaction reasonably available for the minority stockholders.'' *Id.* at 415–16.

[13] *See Hallmark*, 2011 WL 863007, at *12–13.

[14] *Southern Peru*, — A.3d —, 2011 WL 4907799, at *1.

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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.'' [15]

The court suggested that a special committee, to be effective, must understand that its role is not merely to approve or reject the controlling stockholder's proposal, but to take all actions necessary to determine whether a particular course of action is advisable, including by considering strategic alternatives.[16] Taking such actions, according to the court, may in fact enhance the committee's negotiating leverage. For example, given the financial advisor's assessment that Southern Peru shares were trading at a premium to their ''fundamental'' value, the special committee could have proposed a go-private transaction. According to the court, this move would have ''probed Grupo Mexico about its own weaknesses, including the fact that Minera seemed to be cash-strapped, having trouble paying its regular bills, and thus unable to move forward with an acquisition of its own.'' [17] Moreover, it would have ''cast doubt on the credibility'' of Grupo Mexico's proposal, giving the special committee enhanced leverage to secure a more favorable deal. Wielding the power of alternatives, according to the court, may also fundamentally change the dynamic of the negotiations, exposing weaknesses in the controlling stockholder's position (e.g., by forcing it to articulate why it is unwilling to become a buyer) and putting the controlling stockholder ''back on its heels.'' [18] In addition, the court suggested that the process of exploring alternatives serves a meaningful function in the committee's decision-making process, consistent with the directors' duty to inform themselves of all material information. As the court stated, ''[w]hat better way to 'kick the tires' of the deal proposed . . . than to explore what would be available to the company if it were not constrained by the controller's demands.'' [19]

[15] *Id.*
[16] *See id.* at *28.
[17] *Id.* at *9.
[18] *Id.*
[19] *Id.* at *28.

Continuing Recommendation

The court also stated that the special committee's failure to reconsider its recommendation in the post-execution, pre-closing period constituted a ''regrettable and important lapse,'' particularly given that the number of shares issued as consideration in the merger was fixed and the transaction did not contain a collar.[20] The court noted that members of the special committee, as directors of Southern Peru, should have been receiving information indicating that Southern Peru was outperforming the financial forecasts on which the committee's recommendation was based. The court suggested that the special committee, under these circumstances, should have approached its financial advisor to obtain an updated financial analysis and reconsidered its recommendation. In this case, while the special committee was permitted to change its recommendation, it did not have the power to terminate the merger agreement. Due to the two-thirds vote requirement and the voting arrangements among the large stockholders, the court found that the special committee's recommendation was useful only to the extent that the special committee carefully reviewed post-signing developments.[21]

Here, the court's views on the special committee's process raise an important practical concern: at what point does a committee need to obtain a ''bring-down'' fairness opinion? Although not cited in the *Southern Peru* opinion, the Delaware Court of Chancery addressed this issue in *In re Unocal Exploration Corp. Shareholders Litigation*.[22] In that case, plaintiffs attacked the transaction by which Unocal Corporation (''Unocal''), which owned 96 percent of Unocal Exploration Corporation (''UXC''), exchanged minority shares of UXC for shares of Unocal in a short-form merger. After making the proposal, Unocal caused UXC to form a special committee to negotiate the terms of the merger. The UXC special committee then hired a financial advisor to render an opinion as to the fairness of the merger. Although Unocal's initial offer contemplated an exchange ratio of 0.5 shares of Unocal stock for each UXC share, the committee's financial advisor indicated that an appropriate exchange ratio would be in the range of 0.53 to 0.55. The parties eventually settled on an exchange ratio of 0.54.

The plaintiffs claimed that the UXC committee ignored clear ''red flags'' in determining that the exchange ratio remained fair and deciding not to seek a bring-down opinion from its financial advisor. In rejecting plaintiffs' arguments, the court noted that, based on the evidence presented at trial, bring-down opinions ''are the exception, not the rule.'' [23] While the court acknowledged that changes between the date of an opinion and the time of closing may be sufficiently significant to render the original opinion unreliable, and suggested that directors would be well advised to seek a bring-down opinion in such circumstances,[24] it found that the UXC special committee had adequately discharged its duties. The UXC special committee had requested that its advisor revise certain portions of the prior analysis and sought confirmation that the advisor remained confident in its opinion. After conducting the additional work, the advisor reported that the exchange ratio remained fair. According to the court, given this record, ''there was no reason to incur the expense of a completely new fairness opinion.'' [25]

Thus, the *Southern Peru* court's statements regarding the special committee's failure to reconsider its recommendation need not be viewed as an obligation to seek and obtain a bring-down opinion in every transaction. Instead, they serve as a reminder that the special committee's work does not end once it has made its recommendation, but rather con-

[20] *Id.* at *36.
[21] *Id.* at *18.
[22] 793 A.2d 329 (Del. Ch. 2000).

[23] *Id.* at 350.
[24] *Id.* In making this assertion, the court pointed to *Behrens v. United Investors Management Co.*, C.A. No. 12876, 1993 WL 400209, at *12 (Del. Ch. Oct. 1, 1993), where the court posited that, in certain circumstances, intervening market changes may be so great that it would require ''diligent directors'' to question how the deal negotiated earlier remains fair to the minority. *Unocal Exploration*, 793 A.2d at 350, n.97. The *Behrens* court stated: ''In that event, the directors' duty of care would require them to inquire into the grounds of the advisor's view, and in such circumstances, then make appropriate disclosure with respect to any material facts they learn. In such a case if the board failed to make that inquiry, its members may have failed in the execution of their duty to make an informed judgment.'' *Behrens*, 1993 WL 400209, at *12.
[25] *Unocal Exploration*, 793 A.2d at 350.

tinues through closing. As a practical matter, in the post-signing, pre-closing period, committees should continue to review information material to the transaction and should be mindful of their duty to update their recommendation if circumstances so require. To this end, special committees should work with their advisors at the front-end to devise an appropriate strategy to ensure this duty is discharged. This may include scheduling regular meetings among the special committee and its advisors in the post-signing period to review developments and consider what, if any, further inquiries or investigations are required. In addition, special committees may consider whether to request, at the outset of a special committee process, that the financial advisor agree to arrangements relating to the rendering of a bring-down opinion.

Conclusion

Although the members of the special committee were dismissed at an earlier stage in the proceedings, the court's post-trial opinion in *Southern Peru* nevertheless provides important guidance to directors and their advisors in managing an effective special committee process. The opinion strongly suggests that special committees should be invested with the full power of the board, including the power to seek strategic alternatives. The *Southern Peru* opinion also confirms that the special committee's role does not end at the time it delivers its recommendation, but extends through the closing of the transaction. In light of this, special committees and their advisors should consider establishing processes to monitor and respond to post-signing developments.

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