
In re Southern Peru Copper Corporation—What Steps does a Special Committee Have to Take?

by Jonathan J. Russo and Meredith Ervine

*At first glance, Southern Peru Copper Corporation (Southern Peru) and its special committee (Committee) appeared to do what they were supposed to do when considering a controlling stockholder transaction—form a special committee of disinterested, sophisticated directors, engage separate, independent financial and legal advisors, request a fairness opinion and obtain super-majority stockholder approval. So why did the Chancellor of the Delaware Court of Chancery (Court) hold that the transaction was unfair and award \$1.3 billion in damages—one of the largest derivative monetary awards in the Court’s history? This Advisory discusses *In re Southern Peru Copper Corporation Shareholder Derivative Litigation*¹ and suggests specific practices that a special committee should consider when evaluating a controlling stockholder transaction.*

Background

The Proposition. Grupo México, S.A.B. de C.V. (Grupo) was the majority stockholder of Southern Peru, an NYSE-listed mining company. Grupo approached Southern Peru with the proposition that Southern Peru purchase Grupo’s 99.15% stake in a privately-held Mexican mining company, Minera México, S.A. de C.V. (Minera), for 72.3 million shares of Southern Peru’s stock valued at \$3.05 billion.

The Process. Southern Peru set up a Committee of disinterested, sophisticated directors to evaluate the stock-for-stock merger. The Committee in turn hired well-regarded financial advisors and legal counsel as its independent advisors and spent eight months considering the proposed merger. The preliminary valuation analyses prepared by the Committee’s financial advisor showed a \$1.4 billion disparity between

¹ *In re S. Peru Copper Corp. S’holder Derivative Litig.*, C.A. No. 961-CS (Del. Ch. Oct. 14, 2011).

Grupo's asking price (based on Southern Peru's publicly traded stock price) and the valuation of Minera (using a discounted cash flow analysis and other analyses). According to the Court, less than two weeks later, the Committee and its financial advisor appeared to have sought to "equalize" the relative values of Southern Peru and Minera by using discounted cash flow analyses and contribution analyses to compare the relative intrinsic values of the two entities. The relative valuation analyses ultimately helped to close the valuation gap, and eventually the parties agreed on a price that was very close to Grupo's original asking price. After receiving a fairness opinion from its financial advisor, the Committee approved the merger and recommended it to the board, which unanimously approved it. Thereafter, more than 90% of the stockholders approved the merger. Between signing and closing, the stock price of Southern Peru increased by 21.7%. A stockholder derivative action was brought alleging that the merger was not entirely fair to Southern Peru and its minority stockholders.

The Review. The transaction was reviewed by the Court in a post-trial, 105-page decision based on the two-pronged "entire fairness" standard—fair process and fair price. Chancellor Leo E. Strine, Jr. found that the transaction was unfair and Grupo and its related directors breached their fiduciary duty of loyalty. The Court entered a judgment for \$1.3 billion and allowed Grupo to satisfy the judgment by returning Southern Peru shares. In reaching this conclusion, Chancellor Strine criticized the Committee for abandoning its focus on whether Southern Peru would get \$3.1 billion in value in the transaction and moving to "relative valuation" analyses. According to the Court, the relative valuation analyses resulted in Southern Peru being valued at less than its stock market trading price—a proven cash value—and Minera's cash flows being "optimized" for purposes of the analyses. Chancellor Strine viewed these facts as evidence that the Committee was only attempting to justify Grupo's price for the proposed merger rather than considering other options. What other options did the Committee have? According to Chancellor Strine, the Committee could have said "no" to the proposed deal or sought to have Grupo make an offer to buy the minority shares in Southern Peru at a premium to market, capitalizing on the possibility that Southern Peru's stock was overvalued. Instead, according to the Court, the Committee put itself in a "controlled mindset"—either accept or reject Grupo's proposal—and used relative valuation analyses to rationalize its approval of the merger, suggesting that the Committee was not willing or prepared to reject the proposal.

Chancellor Strine also criticized the Committee for maintaining its recommendation of the merger even though Southern Peru was far outperforming the projections on which the deal was based (beating 2004 EBITDA estimates by 37%) and its stock price was steadily rising in the months leading up to the stockholder vote. The fiduciary out that the Committee obtained in the merger agreement provided only that the Committee could change its recommendation of the merger; it did not permit the Committee to terminate the agreement or avoid a stockholder vote. The Court noted that the Committee did not reconsider the contribution analyses or make any effort to update its fairness analysis by requesting an updated fairness opinion from its financial advisor or otherwise. Due to a fixed exchange ratio in the merger without a collar and Southern Peru's increased share price, the final value of Southern Peru stock delivered to Grupo was \$3.75 billion, significantly higher (\$0.7 billion) than the value Grupo initially sought in consideration for Minera.

Chancellor Strine noted that several "concessions" asserted to have been made by Grupo in the negotiations (including the requirement of approval by two thirds of the outstanding stock and a fixed exchange ratio) did not close the fairness gap. The Court indicated that the two-thirds super-majority requirement was not meaningful because (i) Grupo would have been successful in achieving a two-thirds vote if either of the next two largest stockholders voted in favor of the merger, (ii) at least one of those stockholders agreed to vote in accordance with the Committee's recommendation, and (iii) the Committee's \$2.095 billion counteroffer was not disclosed. Chancellor Strine also found it difficult to understand why the Committee agreed to a fixed exchange ratio in light of its belief that copper prices were rising and Minera was not publicly traded.

For all of these reasons, the Court found that the Committee agreed to give away over \$3 billion worth of actual cash value in exchange for something worth demonstrably less—without using any of its contractual leverage to stop the deal or renegotiate the terms.

Suggested Best Practices for a Special Committee

The following are some suggested best practices to consider when evaluating a controlling stockholder transaction in light of Chancellor Strine's decision.

Ensure the Mandate of the Special Committee is Sufficiently Broad. Chancellor Strine noted that the Southern Peru board authorization of the Committee did not expressly authorize it to negotiate or consider alternative transactions and the testimony of the Committee members evidenced their lack of certainty about whether the Committee could do more than just evaluate the proposed merger. While the Committee may have suspected that Grupo would have rejected alternative transactions, Chancellor Strine indicated it should have at least considered and suggested alternatives, which would not have been a useless exercise even if Grupo would have rejected them because it could have changed the negotiating dynamic. A special committee should seek the express power to negotiate or reject the transaction and explore the feasibility of other strategic alternatives, including those that would be available to the company if it weren't constrained by the control of a majority stockholder, since doing so could provide the committee with more negotiating leverage. Of course, a controlling stockholder can always reject any alternative transaction.

Don't Ignore Red Flags or Attempt to Rationalize the Controlling Stockholder's Proposal. The financial advisor's initial presentations to the Committee indicated that Minera's value was significantly below Grupo's asking price and, in Chancellor Strine's view, should have been red flags signaling that the proposed merger was not a fair bargain. Instead of using that as a basis for seeking to negotiate a more favorable deal, Chancellor Strine indicated that the Committee and its financial advisor appeared to have abandoned market price as a measure of value and relied instead on alternative valuation analyses, suggesting that they were merely looking for ways to rationalize the proposed merger. A special committee should focus on fundamental valuation metrics, test the assumptions underlying the transaction and analyses, avoid actions that would appear to rationalize a transaction proposed by a controlling stockholder and demonstrate on the record that it is willing and prepared to say "no" to the proposal.

Consider Any Changed Circumstances and Revise the Recommendation if Necessary. During the five-month period between the Committee's vote and the closing of the merger, Southern Peru exceeded the projections the Committee used in considering the merger by 37% and its stock price rose significantly. Given these facts, and because the merger consideration was determined on a fixed ratio basis without a collar, Chancellor Strine found that circumstances changed considerably and the Committee should have updated its fairness analysis and reconsidered, and if necessary reversed, its recommendation. A special committee should consider whether any change in circumstances in the executory pre-vote period would affect its fairness analysis and require it to update its financial analyses, change its recommendation or cause additional disclosures.

Special Stockholder Approval Conditions Need to be Up-front and Tailored to the Proposed Transaction. Chancellor Strine rejected the defendants' arguments that the two-thirds super-majority condition and more than 90% stockholder approval were evidence of fair process in part because the stockholder approval condition was satisfied if either of the two next largest stockholders after Grupo voted in favor of the merger and Grupo had assurances from them that they would do so. In negotiating the terms of a proposed transaction, a special committee should seek up-front an unwaivable majority of the minority vote condition (merely obtaining such a vote, without having made it an up-front condition, is not sufficient)

or consider tailoring the super-majority stockholder approval requirements to address the composition of the particular stockholder base.

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