

Litigation Alert

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When a Special Committee Is Not So Special: Delaware Supreme Court Affirms Decision Holding Controlling Shareholder and Affiliated Directors Liable for More Than \$2 Billion Stemming from Related-Party Transaction

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Sometimes, a special committee is not so special. On August 27, 2012, the Delaware Supreme Court upheld a Chancery Court decision ordering the controlling shareholder of Southern Copper Corporation, formerly Southern Peru Copper Corporation, and its directors affiliated with the controlling shareholder to pay more than \$2 billion for breaching their fiduciary duty. The breach stemmed from Southern Copper's acquisition of another entity almost entirely owned by the controlling shareholder. The hammer came down despite the existence of the recognized insulating measure of a special committee of independent directors.

In *In re Southern Peru Copper Corporation Shareholder Derivative Litigation*,¹ Chancellor Strine peeled away the veneer of ostensibly good special committee practice, looking very carefully at the "substance, and efficacy, of the negotiations" by the special committee, and found that the acquisition was not entirely fair, regardless of who had the burden of persuasion. In affirming, the Delaware Supreme Court² emphasized that the procedural benefit of shifting the burden of persuasion to the plaintiff which may be obtained by either the favorable recommendation of a well-functioning special committee of independent directors or an informed approving vote of a majority of the minority shareholders is "modest." The Court held that, where the complicated facts of the case prevent a determination of who bears the burden of persuasion prior to trial, the burden remains on the defendant to prove the entire fairness of the transaction.

The case serves as a cautionary tale to all controlling shareholders seeking to effect related-party transactions and provides instruction to special committees tasked with protecting the interests of corporations and their shareholders in related-party transactions with controlling shareholders.

[Controlling Shareholders' Fiduciary Duties in Delaware](#)

Similar to the fiduciary status of directors and officers of a corporation, in Delaware, a controlling shareholder is a fiduciary to the corporation and its minority shareholders. *In re Maxxam*, 659 A.2d 760, 771 (Del. Ch. 1997). While Delaware law does not prohibit controlling shareholders from engaging in transactions with the corporations that they control, Delaware courts will apply the entire fairness standard of review to such transactions when challenged. Under this exacting standard, the burden of persuasion will shift back to the challenging party if the transaction is recommended by a well-functioning special committee of independent directors or if there is an informed approving vote by a majority of the minority shareholders.

[Underlying Transaction](#)

In 2004, Southern Copper's controlling shareholder, Grupo Mexico, offered the company the opportunity to buy Grupo Mexico's 99.15% ownership interest in Minera, a Mexican mining company, in exchange for approximately \$3 billion worth of Southern Copper stock. Southern Copper created a special committee of independent directors

to evaluate, but not expressly mandated to negotiate regarding or to explore alternatives to, the proposal. The special committee gave the appearance of objectivity, hiring separate legal and financial advisors (who provided a fairness opinion), as well as a specialized mining consultant, and considering their advice. But, rather than rejecting Grupo Mexico's inadequate proposal and negotiating for more favorable terms or seeking a superior alternative, the special committee iteratively and selectively considered valuation methodologies to justify the terms pressed by Grupo Mexico. In addition, the final transaction terms were stale by the time of the closing of the merger – with the value of Southern Copper's stock issued as consideration having increased by more than 20% since signing. The special committee did not seek an updating of the financial advisors' fairness opinion and did not reconsider its recommendation. According to the Chancery Court, as affirmed on appeal, Southern Copper overpaid Grupo Mexico by nearly \$1.3 billion for Minera, thereby harming Southern Copper and also its minority shareholders. Accrued interest brought the award to over \$2 billion and over \$300 million in plaintiff's fees were awarded. Although the shareholders approved the transaction by a 90% favorable vote, that vote did not shift the burden of persuasion as the transaction was not made subject to a condition of approval by a majority of the minority and, further, obtaining the two-thirds requisite vote was assured inasmuch as it was apparent that Grupo Mexico and the next two largest shareholders were intent on voting to approve. Chancellor Strine also found that the minority shareholders were not fully informed by the proxy statement and road show presentation for the transaction as there were deficiencies in each.

Appeal to the Delaware Supreme Court

The defendants raised five issues on appeal, all of which were rejected by the Delaware Supreme Court. The most relevant issue for future litigants decided by the Court was the defendants' contention that the Chancery Court committed reversible error by failing to determine which party bore the burden of proof prior to trial. The defendants argued that the burden of proof should have been allocated to the plaintiff because the special committee was independent, well-functioning, and did not rely on the controlling shareholder for information that formed the basis of their recommendation. The Delaware Supreme Court disagreed.

The Court explained that, in order to encourage the use of procedural devices that foster fair pricing, such as special committee recommendation and majority-of-the-minority shareholder approval conditions, the Court will provide defendants the "modest procedural benefit" of shifting the burden of persuasion on the ultimate issue of entire fairness to plaintiffs. This creates a practical problem where the pretrial record is insufficient to determine which party bears the burden of persuasion. The Court resolved this problem by holding that, in future cases, "if the record does not permit a pretrial determination that defendants are entitled to a burden shift, the burden of persuasion will remain with the defendants throughout the trial to demonstrate the entire fairness of the interested transaction."³ The Court also held that the Chancery Court did not commit reversible error by failing to determine which party bore the burden of persuasion prior to trial.

As a result of the Court's decision, there is no guarantee that the recommendation of a related-party transaction with a controlling shareholder by a special committee of independent directors or approval by a majority of the minority shareholders will shift the burden of persuasion of entire fairness to the plaintiffs if the transaction is later challenged. Nevertheless, as explained by the Court, "the effective use of a properly functioning special committee of independent directors and the informed conditional approval of a majority of minority stockholders will continue to be integral parts of the best practices that are used to establish a fair dealing process."⁴

Lessons Learned – Substance over Form

In the aftermath of *Southern Peru Copper*, members of Boards of Directors and special committees should be even more cautious when discharging their duties with respect to transactions with controlling shareholders. When a special committee is created, the Board should empower the committee with real bargaining power and allow it to explore alternatives to the controlling shareholder's proposal. Once tasked with their mandate, the special committee should act as a true and independent third-party negotiator to extract the best deal possible for the corporation and its shareholders. In doing so, special committees should not re-tool the valuation methodologies to become outcome-determinative, and they should revisit valuation if there are changes in material circumstances.

Lastly, in order for a shareholder vote to shift the burden of persuasion of entire fairness, the majority-of-the-minority vote must be a condition of the transaction and it must be "meaningful." That is, the minority shareholders must be fully informed regarding the transaction.

The missteps in *Southern Peru Copper* highlight some of the pitfalls for Boards, special committees and controlling

shareholders. If you require assistance in this area or would like to discuss the decisions in *Southern Peru Copper* further, please contact either author.

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Endnotes

¹ *In re Southern Peru Copper Corp. S'holder Deriv. Litig.*, ___ A.3d ___, 2011 WL 6440761 (Del. Ch. Dec. 20, 2011).

² *Americas Mining Corp. v. Theriault*, No. 29, 2012 (Del. Aug. 27, 2012).

³ *Id.* at *65.

⁴ *Id.* at *66.

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