

## Delaware Supreme Court Changes Law on Burden Shifting in Conflict of Interest Cases and Upholds Huge Damages and Attorney Fee Award

In a highly anticipated decision, on August 27, the Delaware Supreme Court upheld Chancellor Leo Strine's October 2011 trial decision in the *Southern Peru Copper* case. The Supreme Court's opinion announced new law on burden-shifting in entire fairness cases—that is, cases where the presence of a controlling shareholder on both sides of the transaction triggers the most searching level of judicial review. Previously in such cases, under *Khan v. Lynch*, the presence of a well-functioning special committee process that was not under the influence of the controlling shareholder would shift the burden to plaintiffs to prove that a transaction was not entirely fair.

Because the question of the effectiveness of a special committee is difficult to resolve at the pleading stage, the clear principle established by *Khan v. Lynch* has often proved difficult to apply in practice. Such was the case in *Southern Peru*, where the Chancellor reserved his decision on which party had the burden of proof until after hearing all evidence. This creates a practical difficulty for parties, whose preparation for and presentations at trial are heavily influenced by which side bears the burden. Under the Supreme Court's decision in *Southern Peru*, in future cases, absent the ability to demonstrate in advance of trial that defendants are entitled to a burden shift in their favor, “the burden of persuasion will remain with the defendants throughout the trial to demonstrate the entire fairness of the transaction.”

The Supreme Court's opinion also reinforced other lessons from the trial. As background, the case involved Southern Peru's acquisition of Minera Mines from the companies' common controlling shareholder, Grupo Mexico. At the time of the transaction in 2004, Grupo Mexico owned 54% of Southern Peru's stock and controlled 63% of its vote. Grupo Mexico “proposed” to Southern Peru's board that Southern Peru buy Grupo Mexico's 99.15% stake in Minera for \$3.05 Billion, payable in Southern Peru stock, which was publicly traded. Southern Peru's stock price at the time was buoyed by strong results and rising demand for copper. Minera, on the other hand, was emerging from a difficult period with over \$1 billion of debt on its books.

In response to the proposal, Southern Peru's board formed a special committee to negotiate with Grupo Mexico. But the Chancellor found that the Special Committee fell victim to the “distorted perspective” of the “controlled mindset and allowed Grupo Mexico to dictate the terms and structure of the merger.” And so when initial valuation methods showed a gap of roughly \$1 billion between Minera's value and Grupo Mexico's ask, the Special Committee's financial advisor developed alternative and result-oriented valuation methods designed to bridge the gap. This involved framing management projections for Minera as optimistically as possible, with Southern Peru's multiples applied to Minera's cash flows. The Chancellor concluded that the Special Committee had done little to press Grupo Mexico off its initial price demand, or to negotiate substantial changes in the deal structure.

The Chancellor found, and the Supreme Court agreed, that this special committee process was defective under both factors relevant to entire fairness: deal process (“fair dealing”) and economics (“fair price”). As for fair dealing, the Chancellor was especially critical of what he saw as the Special Committee's supine approach to its negotiations with Grupo Mexico. The Supreme Court's opinion adopted the Chancellor's conclusions effectively verbatim, reiterating the message that, to be effective and independent, a special committee must have a robust mandate to negotiate a range of options. If not, the committee's effectiveness is in question, and it risks subordinating the interests of other shareholders to those of the controller.

Such failures under the “fair dealing” prong of entire fairness are almost inevitably connected to failures under “fair price” factor. And so in *Southern Peru*, the Supreme Court echoed the Chancellor’s criticism of the “blinkered perspective” of the committee’s valuation process. Faced with an initial analysis that identified a billion dollar gap in value, the committee, rather than pressing hard on price, worked with its financial advisor “to rationalize the one strategic option available to it within the controlled mindset that pervaded the Special Committee’s process.”

The key lesson of *Southern Peru*—the need for special committees in controlling-party transactions to be free of disabling conflicts of interest, have robust mandates and employ those tools fully to the benefit of minority shareholders—is a tried and true principle of Delaware law. Indeed, the case is notable for the number of ways in which the transaction process went awry: the narrow mandate of the committee, the perceived passivity of its members, conflicts of interest, and the financial gymnastics used by the committee and its advisors to rationalize what the Court saw as an obviously bad deal, to name a few.

Defendants should continue to presume, absent a clear finding pre-trial, that they bear the burden of proof. And a well-functioning special committee will remain the best way to demonstrate the fair dealing and fair price needed to satisfy the entire fairness standard in situations where an independent special committee is feasible and appropriate. It is possible that the Supreme Court’s new approach will have an impact on pre-trial pleading strategies, but it should not change fundamental deal practice.

The Supreme Court also upheld the Chancellor’s award of just over \$2 billion in damages and interest to Southern Peru, and of \$301 million in fees and costs to Plaintiff’s attorneys, all payable by Grupo Mexico. Admitting that the damages award was significant, the Supreme Court nevertheless upheld it as a reasoned estimation of the difference between the price actually paid for Minera and the price that Grupo Mexico would have paid had the deal been entirely fair. In effect, Southern Peru has been awarded a partial refund on the purchase price.

Finally, the Supreme Court’s upholding of the significant fee award is also notable. The \$301 million represented roughly 15% of the “common fund” created by the judgment. While large in absolute numbers, this award was on the low end of percentages for fee awards in similar cases involving a full trial. The Supreme Court voiced continued support for the calculation of fees based on a percentage of the common fund. In doing so in this case, it left open the continued possibility of exceptional awards in other Delaware shareholder litigation.

If you have further questions, please contact your Ropes & Gray advisor.