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Special Transaction Committees

Special Committee Review after *Southern Peru Copper*

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Chancellor Strine's latest opus, *In re Southern Peru Copper Corp. S'holders Derivative Litig.*,[1] contains a number of eye-catching features, including (not least) a $1.2 billion damages award, a potential bring-down requirement for fairness opinions in certain circumstances, clarifications regarding disclosure of the negotiation process, a discussion of the effect of roadshow presentations on the total mix of information available to stockholders, and a particularly intense scrutiny of the work of the financial advisor. Arguably the most interesting aspect of the decision, however, is the court's finding that to shift the burden of proof regarding entire fairness from defendant to plaintiff, the special committee, in addition to being structurally independent, must also be "effective." In the words of Chancellor Strine, the court must examine "the substance, and efficacy, of the special committee's negotiations, rather than just . . . look at the composition and mandate of the special committee."[2]

Briefly, the case involved an offer by Grupo México to sell to its majority-owned subsidiary, Southern Peru Copper, Grupo México's interest in another of its subsidiaries, Minera México. Given that this was a transaction between Southern Peru and its controlling stockholder, a special committee of four independent Southern Peru directors was set up to evaluate Grupo México's offer. Delaware courts generally will review such transactions under an "entire fairness" standard–meaning that the transaction must be entirely fair to minority stockholders, both as to process and as to price.[3] Use of an independent special committee shifts the burden of proof under this standard from defendant to plaintiff.[4] Thus, care typically is taken to ensure that the special committee is composed of truly independent directors and that those directors are given a mandate sufficient to allow them to represent the minority stockholders effectively. Here, however, the court evaluated not just these structural matters, but also the effectiveness of the special committee in the negotiation process, before determining whether shifting the burden of proof was appropriate.

Special Committee Composition and Mandate

Before getting to what makes a special committee "effective," it is worth spending a few paragraphs on the court's view of the composition and mandate of this special committee.

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– Committee Member's Desire for Liquidity Tainted His Independence

First, as to composition, the court found that the special committee members "were competent, well-qualified individuals with business experience" and that the special committee "was given the resources to hire outside advisors, and it hired not only respected, top tier of the market financial and legal counsel, but also a mining consultant and Mexican counsel."[5] The court also found that "the members of the Special Committee met frequently."[6] However, the court also found that one of the special committee members, appointed by a significant minority stockholder, was "operating under a constraint that was not shared by all stockholders, which was his employer's desire to sell its holdings in Southern Peru."[7] This meant that the member "may not have been solely focused on paying the best price in the Merger . . . because he had independent reasons for approving the Merger."[8] More pointedly, the court found that the simultaneous negotiation by this member with the controlling stockholder, his seeking of registration rights for the minority stockholder that such member represented, and the apparent linking of registration rights with the approval of the merger in draft term sheets, meant that the minority stockholder's "important liquidity concern had the undeniable effect of extinguishing much of the appetite that one of the key negotiators of the Merger had to say no. Saying no meant no liquidity."[9]

It is not difficult to understand the court's concern with the negotiation by the member for additional liquidity rights in the context of the merger negotiations. The court cites *Merritt v. Colonial Foods, Inc.*: "The law . . . will accord scant weight to the subjective judgment of an interested director concerning the fairness of a transaction that benefits him."[10] More difficult to understand is the court's view that the member "was in an odd place to recommend to other stockholders to make a long-term strategic acquisition," given that the minority stockholder he represented "had no intent of sticking around to benefit from the long-term benefits of the Merger."[11] Presumably, this will not be read as a requirement that members of special committees must be appointed by minority stockholders with the same investment time-horizon as all other minority stockholders–that would indeed be a difficult rule with which to comply. It may, however, point to a need to carefully evaluate whether a director appointed by a stockholder holding a material equity interest has an investment horizon–whether long or short–that may strongly influence the director's personal view of the merits of a proposed transaction or otherwise cause a potential misalignment with other stockholders. In the end, the court found that the member had not "consciously acted in less than good faith."[12] Accordingly, while the member was not subjected to personal liability, the court clearly did consider his participation in the negotiation of the merger to be less than ideal.

– Committee Lacked Clear Power to Negotiate or Evaluate Alternatives

As to the mandate of the special committee, the court had a number of objections, and pointed to the weak mandate as the root of the problem with the special committee process. The mandate empowered the special committee only to "evaluate" the proposal of the majority stockholder. It did not empower the special committee to engage in negotiations with the majority stockholder. The special committee did in fact engage in such negotiations, but the court found that the special committee's "approach to negotiations was stilted and influenced by its uncertainty about whether it was actually empowered to negotiate."[13] The mandate did not empower the special committee to evaluate alternatives, and the special committee's failure to insist on this right influenced the court's "ultimate determination of fairness, as it took off the table other options that would have generated a real market check and also deprived the Special Committee of negotiating leverage."[14]

Burden Shifting May Require a Full Trial

Given the defects in composition and mandate, perhaps it is an overstatement to say that a court, following Chancellor Strine's decision, could never find an effective special committee (and hence determine burden shifting) until after trial. If a court were presented with a pre-trial record showing that the board was fully independent and had a strong mandate, it might not feel the need to judge how effective the special committee's performance was after a full trial on the subject. But the court in *Southern Peru* does not leave itself this escape route or shy away from the practical implications of its ruling, acknowledging that "questions of whether the special committee was substantively effective in its negotiations with the controlling stockholder–questions fraught with factual complexity–will, absent unique circumstances, guarantee that the burden shift will rarely be determinable on the basis of the pre-trial record alone."[15]

– Possible Effect on Settlements

Chancellor Strine, however, does not necessarily view with consternation the implied requirement that there be a trial to determine burden shifting. In this decision and in *In re Cysive, Inc. S'holders Litig.*,[16] he states that there is little practical benefit to shifting the burden of proof under a preponderance standard, unless the court is "stuck in equipoise about the issue of fairness."[17] While this is no doubt correct when considering the effect on the court's decision at trial, it may not be correct to infer that the finding will have little practical effect on settlement. One could argue that the fact that the burden shift may not be determined on the basis of a pre-trial record will mean that the defendant's leverage in settlement is reduced, as summary judgment may not be available regardless of how strong the record may seem to be. However, in a recent (and admittedly limited) survey presented at Widener University School of Law by Cleary Gottlieb[18] of 19 controlling stockholder buyouts involving merger agreements, litigation was pursued in 16 of the transactions, and only one

litigation was dismissed on the pleadings. (The dismissed case was not a Delaware case.) Given the rarity of getting a case dismissed on the pleadings, it would seem that Chancellor Strine may have been correct to minimize the importance of his finding on the dynamics of settlement.[19]

– Possible Effect on Majority-of-the-Minority Provisions

One could also inquire as to whether Chancellor Strine's burden shifting ruling will drive practitioners to recommend using a "majority-of-the-minority" condition–conditioning the transaction on the approval of a majority of the non-controlling stockholders–to shift the burden of proving entire fairness to plaintiffs. While inclusion of a majority-of-the-minority condition presumably is still sufficient in itself to result in a burden shift to the plaintiff, it has often been viewed as less palatable to the controlling stockholder than use of a special committee–not for any insidious reason regarding suspect loyalties of special committee members, but rather because of the ease with which a number of hedge funds and other stockholders, in certain circumstances, can accumulate a blocking position in the minority shares, thereby facilitating the extraction of an additional premium from the controlling stockholder. Unlike a special committee which must come to terms with the controlling stockholder before signing up and announcing a deal, a hedge fund with a blocking position generally does not have to come to terms with the controlling stockholder at any point before the expiration of the tender offer, potentially leading to an extended period of deal uncertainty after announcement. The use of a tender offer with a majority-of-the-minority condition also is more difficult to coordinate with the settlement process than a special committee process, where negotiations with plaintiff's counsel often proceed simultaneously with negotiations with the special committee. As the goal is typically to avoid litigation altogether, rather than to win at trial, the inclusion of a majority-of-the-minority condition in transactions structured as tender offers may continue to be viewed as a less favorable substitute for a special committee process with simultaneous settlement negotiations, even if the heightened requirements associated with an "effective" special committee process do in fact lead to increased settlement leverage for plaintiffs.

– Possible Effect on the Applicable Standard of Review

Perhaps even more interesting is the effect the court's finding is likely to have on the doctrinal framework promoted by Chancellor Strine and Vice Chancellor Laster in *In re Pure Resources*[20] and *CNX Gas Corp. S'holder Litig*.[21] In those cases, the respective courts advocated that the business judgment rule, rather than entire fairness, be the applicable standard of review for controlled mergers/acquisitions (whether effected by a tender offer or merger) if the transaction had been approved by a robust special committee and included a non-waivable majority-of-the-minority condition. Any temptation of a controlling stockholder to follow this paradigm and forego settlement would seem to be greatly diminished by Chancellor Strine's view that the effectiveness of the special committee will "rarely be determinable on the basis of the pre-trial record alone."[22] Given the searching nature of the inquiry as to the "effectiveness" of the special committee, the application of the business judgment rule only after a determination of "effectiveness" has been made will likely not be viewed as a great benefit. In short, we seem to be left where we started, with settlement being the only method of avoiding a trial on entire fairness in a controlled transaction context.

[1] *In re S. Peru Copper Corp. S'holder Deriv. Litig.*, 30 A.3d 60, 2011 BL 265414 (Del. Ch. 2011).

[2] *Id.*at 89-90.

[3] *See Kahn v. Tremont Corp.*, 694 A.2d 422, 428-29 (Del. 1997).

[4] *See Kahn v. Lynch Communications Systems, Inc.*, 638 A.2d 1110, 1115 (Del. 1994).

[5] *Southern Peru* at 97.

[6] *Id.*

[7] *Id.* at 99.

[8] *Id.*

[9] *Id.* at 100.

[10] *Id.* at 99 and n.139 (quoting *Merritt v. Colonial Foods, Inc*, 505 A.2d 757, 765 (Del. Ch. 1986)).

[11] *Id.* at 100.

[12] *Id.*

[13] *Id.* at 97-98.

[14] *Id.* at 98.

[15] *Id.* at 92.

[16] *In re Cysive, Inc. S'holders Litig.*, 836 A.2d 531, 548 (Del. Ch. 2003).

[17] *Southern Peru* at 93.

[18] As cited in "Putting the Law in the Back Seat" by David Marcus, *Corporate Control Alert*, The Deal Magazine, p. 19 (May 2011).

[19] These findings would come as no surprise to Chancellor Strine, who has noted that "it was impossible after [*Kahn v. Lynch*] to structure a merger with a controlling stockholder in a way that permitted the defendants to obtain dismissal of the case on the pleadings." *In re Cox Communications, Inc. S'holders Litig.*, 879 A.2d 604, 622 (Del. Ch. 2005).

[20] *In re Pure Res., Inc. S'holder Litig.*, 808 A.2d 421 (Del Ch. 2003).

[21] *In re CNX Gas Corp. S'holder Litig.*, 4 A.3d 397 (Del. Ch. 2010).

[22] *Supra* note 15.