Delaware Supreme Court Affirms Award of More than $2B in Damages (including interest) and $304M in Attorneys' Fees

In December 2011, Chancellor Strine awarded $2.03 billion in damages, including interest (believed to be the largest single monetary award by the Chancery Court) in a stockholder action challenging the acquisition by Southern Peru Copper Corporation ("Southern Peru") of Minera México, S.A. de C.V. ("Minera") from Americas Mining Corporation ("AMC"), for $3.05 billion in Southern Peru stock. Grupo México, S.A.B. de C.V. ("Grupo México") was the parent company of AMC, which owned both a 99.15% stake in Minera and a controlling interest in Southern Peru. The minority stockholders of Southern Peru brought a derivative action against defendants AMC, the Grupo México affiliated directors of Southern Peru and members of the Southern Peru Special Committee (as defined below) alleging that the transaction was entirely unfair to Southern Peru and its minority stockholders.

The Decision of the Chancery Court

In February 2004, Grupo México proposed that Southern Peru buy its 99.15% stake in Minera in exchange for shares of Southern Peru stock. Minera had no market-tested value, while Southern Peru was publicly traded. Southern Peru formed a special committee of disinterested directors to consider the transaction with Grupo México (the "Special Committee"). The powers of the Special Committee were fairly limited: its "duty and sole purpose" was "to evaluate the [merger] in such manner as the Special Committee [deemed] to be desirable and in the best interests of the stockholders of [Southern Peru]…" The Special Committee was not expressly authorized to explore other strategic alternatives or negotiate the proposed transaction with AMC. The Special Committee and Board of Directors of Southern Peru ultimately approved an acquisition of the 99.15% stake in Minera in exchange for 67.2 million shares of Southern Peru stock (a market value of $3.1 billion on the date of approval and execution of the merger agreement and $3.75 billion on the date that the merger closed). The derivative suit was then initiated.

The Chancery Court applied the *entire fairness* standard and found the transaction unfair due, among other things, to the use of unconventional "relative" value metrics reflecting the projected relative contributions of cash flows of the combined entities which ignored the true market value of the Southern Peru stock and improved the value of the equity of Minera. It was alleged that Goldman, Sachs & Co. ("Goldman"), the

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Special Committee's financial advisor, never derived a value for Minera that justified paying Grupo México's asking price. Instead it allegedly relied on a "relative" valuation analysis that compared the discounted cash flow ("DCF") values of the two companies, and a contribution analysis that improperly applied Southern Peru's own market EBITDA multiple (and other higher multiples) to Minera's EBITDA projections, to determine the exchange ratio for the merger. The plaintiffs claimed that by abandoning Southern Peru's market price as a measure of the value of the merger consideration, Southern Peru substantially overpaid for Minera.

The Chancery Court held that the Special Committee had not been well served by its financial advisors who made numerous efforts to justify a price requested by Grupo México. The Chancery Court also criticized the Special Committee's mindset, which the Chancery Court perceived as trying to justify the fairness of the transaction proposed by its controlling stockholder.

Therefore, the Chancery Court awarded damages in the amount of the difference between the actual price paid and what the price should have been if the transaction had been fair, plus interest.

The Defendants' Arguments on Appeal and the Delaware Supreme Court's Decision

The defendants mounted a vigorous challenge to the Chancery Court's decision on five issues. The Supreme Court affirmed the decisions of the Chancery Court on all five issues noting that these matters were properly within the Chancery Court's discretion and the Chancellor's conclusions had each been the result of a logical reasoning process.

First, the defendants contended that the Chancery Court improperly denied the defendants the opportunity to present a witness from Goldman to explain its valuation process on the grounds that the witness constituted an "unfair surprise."

Second, the defendants argued that the Court of Chancery erred by failing to determine which party bore the burden of persuasion before trial and also erred in ultimately allocating the burden of persuasion to defendants because the Special Committee was independent and well-functioning, and did not rely on Grupo México for the information forming the basis for its recommendation. Under Delaware law, a controlling stockholder has the burden of proving an interested transaction is entirely fair to the minority stockholders. When the entire fairness standard applies, in order to encourage the use of special committees and minority stockholder approval conditions, Delaware courts have allowed the defendants to shift the burden of persuasion to the plaintiffs by either (i) showing that the transaction was approved by a well-functioning committee comprised of independent directors or (ii) showing that the transaction was approved by an informed vote of the target's minority stockholders. The Chancery Court found that it could not determine whether the burden of persuasion could be shifted early in the litigation. Further, it held that the burden of persuasion remained with defendants because the Special Committee was "not functioning," but that such determination was of little practical effect because the merger was unfair to Southern Peru and its stockholders. The Supreme Court noted the "modest benefit" to be gained by the shift and that the failure to shift the burden is not outcome determinative. In dicta, the Supreme Court held that if the pretrial record does not permit a burden shift, the burden of persuasion remains on the defendants throughout the trial to determine the entire fairness of the interested transaction. At the end of the day, however, as in most cases involving entire fairness, burden shifting has little, if any, effect on the outcome.

Third, the defendants argued that the Chancery Court's determination of "fair" price for the transaction was "arbitrary and capricious" because the Chancery Court did not separate its analysis between fair dealing and fair price. The Supreme Court stated that "[a]lthough the entire fairness standard has two components, the entire fairness analysis is "not a bifurcated one as between fair dealing and fair price. All aspects of the issue must be examined as a whole since the question is one of entire fairness. … The paramount consideration, however, is whether the price was a fair one." The Chancery Court found that the members of the Special Committee were competent and well qualified, but that they "fell victim to a controlled mindset and allowed Grupo México to dictate the terms and structure of the [m]erger." The Chancery Court noted that the Special Committee did not attempt to have its limited mandate expanded so that it could consider other alternative transactions, but instead "accepted that only one type of transaction was on the table, a purchase of Minera by Southern Peru." The Chancery Court found that the transaction process constituted unfair dealing and resulted in an unfair price. The Supreme Court held that the Chancery Court applied a "disciplined balancing test" and considered both fair dealing and fair price "in a comprehensive and complete manner." The Supreme Court affirmed the Chancery Court's judgment that the merger consideration was not entirely fair.

Fourth, the defendants argued that the award of damages by the Chancery Court was not supported by the evidence in the record, but rather by "impermissible speculation and conjecture." Defendants argued that the merger consideration was more than fair because Southern Peru's stock had increased in price in the years after the merger and because the plaintiffs delayed litigating the case. Because of the plaintiffs' delay in litigating the case, the Chancery Court rejected the rescissory damages requested by the plaintiffs. Instead, the Chancery Court awarded damages based on the difference in value between what was paid and the value of what was received in the transaction. To calculate "fair" price, the Chancery Court balanced three separate values: (1) the standalone DCF value of Minera; (2) the market value of Minera as reflected in a 52 million share counteroffer made by the Special Committee; and (3) the equity value of Minera derived from an analysis of comparable companies. The Chancery Court calculated the average of these three values (subject to certain adjustments), resulting in an approximately $1.35 billion damage award. It then added interest from the merger date until the date of payment at the statutory rate, without compounding, for a total judgment of approximately $2.03 billion. The Supreme Court held that the Chancery Court "properly exercised its broad historic discretionary powers in fashioning a remedy and making its award of damages."

Finally, the defendants argued that the Chancery Court's award of attorneys' fees in excess of $304 million was an abuse of discretion, in effect awarding the plaintiffs' attorneys an hourly rate of $35,000. The Supreme Court held, with Justice Berger dissenting, that the Chancery Court properly considered and applied each of the factors set forth in *Sugarland Industries, Inc. v. Thomas*[1] resulting in its decision to award attorneys fees and expenses equal to 15% of the amount of the "common fund," in an exercise of its broad discretion under *Sugarland*. It remains to be seen whether this fee award will encourage plaintiffs to "go for broke" and decline to settle entire fairness cases.

Key Takeaways

- In order to get any protection, a special committee in a controlling stockholder transaction needs a robust mandate to enable it to engage in arms' length negotiations.
- Where a special committee is not a "well-functioning" committee, the burden of persuasion will remain with a defendant.
- If a burden shift is not permitted by the pretrial record, the defendants retain the burden of persuasion to determine the entire fairness of the interested transaction.

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[1] In *Sugarland*, the Supreme Court set forth the following factors to be considered and weighed by the Chancery Court in determining an equitable award of attorneys' fees: "(1) the results achieved; (2) the time and effort of counsel; (3) the relative complexities of the litigation; (4) any contingency factor; and (5) the standing and ability of counsel involved. Delaware courts have assigned the greatest weight to the benefit achieved in litigation."