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The Value of A Well Functioning, Independent Special Committee Is Highlighted by the Recent Delaware Chancery Decision, In Re Southern Peru

The recent case of In re Southern Peru Copper Shareholder Derivative Litigation, C. A. No. 961- CS (Del. Ch. October 14, 2011) demonstrates the value of an independent, well-functioning board or committee in negotiating an acquisition transaction. A controlling stockholder sold another company it controlled to the controlled company for \$3.1 billion of the controlled company's stock (which grew to almost \$3.7 billion as a result of appreciation in the controlled company's stock between signing and closing); the Chancery Court found that the target was worth no more than \$2.4 billion and required the controlling stockholder to return approximately \$1.3 billion of stock to the controlled company buyer. The process by which the Special Committee evaluated and negotiated the transaction was subjected to extensive criticism by the Chancery Court.

Summary

Grupo Mexico owned 54.1% of Southern Peru's outstanding capital stock and 63.08% of the voting power. Southern Peru was a NYSE-based company. Grupo Mexico also owned 99.15% of the stock of Minera, a company engaged in mining copper and other metals. Grupo Mexico's chairman was also chairman and CEO of Southern Peru. Minera was in financial difficulty, and severely cash constrained, while Southern Peru was in good financial condition and virtually debt free.

Grupo Mexico proposed that Southern Peru purchase its stake in Minera for 72.3 million shares of Southern Peru stock, worth \$3.05 billion. Southern Peru formed a Special Committee to "evaluate" the transaction. Eight months later, after a lengthy negotiation, the Special Committee approved Southern Peru's acquisition of Grupo Mexico's stake for 67.2 million shares. The value on the date of announcement of 67.2 million shares was \$3.1 billion, just the value that Grupo Mexico had sought; by the closing the value of these shares had grown to \$3.75 billion.

After a review of the Special Committee process and the terms of the transaction, the Chancery Court held that the transaction was unfair to Southern Peru's minority stockholders, and fashioned a remedy requiring the controlling stockholder to give up shares approximating the difference between the fair price and the value of the 67.2 million as of the merger.

The Special Committee's Consideration of the Minera Transaction

The resolutions establishing the Southern Peru Special Committee indicated that the “duty and sole purpose” of the Special Committee is to evaluate the [merger] in such a manner as the Special Committee deems to be desirable and in the best interests of the company,” and authorized the Special Committee to engage legal and financial advisors at Southern Peru’s expense. Goldman Sachs and Latham & Watkins were engaged to represent the Special Committee. The resolutions did not give the Special Committee the express power to negotiate, nor did they authorize the Special Committee to explore other strategic alternatives.

Goldman initially provided various valuation analyses of the target, Minera, including a DCF analysis, a contribution analysis, and a look through (sum of the parts) analysis. These valuations showed that Minera was worth no more than \$1.7 billion. The Southern Peru stock was publicly traded, and an important assumption, never challenged, was that the block of Southern Peru shares to be issued (at this point, 85% of the then-outstanding Southern Peru stock) would yield a cash value equal to its current trading price. The initial Goldman analysis showed that the proposed Southern Peru shares to be issued were worth \$3.1 billion. The Goldman analyses which showed this significant disparity between the value of Minera and the Southern Peru stock, was never repeated during the transaction process, despite ongoing subsequent evaluation by the Special Committee of the transaction.

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Instead, shortly after this initial presentation, Goldman provided the Special Committee with a DCF analysis for Southern Peru, showing that the Southern Peru fundamental value was worth less than its current market capitalization, a result which might have been due to revised assumptions for the Southern Peru DCF analysis from those used for the Minera analysis. This Southern Peru DCF analysis reportedly “comforted” the Special Committee, since the differential in value between Minera and the stock being requested was reduced under this new analysis, with the deal being shown to have Southern Peru giving \$2.06 billion in value for \$1.7 billion in assets. Thereafter Goldman presented a variety of analyses valuing the two companies on a relative basis. They compared the two companies using “the same set of assumptions and methodologies, rather than comparing Southern Peru’s market capitalization to Minera’s DCF value.”

The Special Committee made a counter proposal to Grupo Mexico for a purchase of Minera for \$2 billion of Southern Peru stock (notably higher than any of the values in the initial Goldman analysis) and proposed to issue a fixed number of shares which would float up and down in value with Southern Peru’s trading price. Grupo Mexico responded by proposing a price of 80 million shares, then worth the

same \$3.1 billion as in its initial term sheet, a proposal rejected by the Special Committee. Grupo Mexico then proposed a price of 67 million shares or then \$2.76 billion in value. The 67 million shares later rose in value to \$3.06 billion. The Special Committee received more analyses presented by Goldman, comparing the two companies' market-based equity values, showing a range of values at the forward EBITDA multiple from 61 to 72 million shares, or \$2.765 billion to \$3.26 billion.

The Special Committee then made a counter proposal of 64 million number of Southern Peru shares (then equal to \$2.975 billion) in current market value. The Special Committee also proposed a 20% collar giving either side the right to terminate if the stock price for Southern Peru went outside the collar and a condition that a majority of the minority stockholders of Southern Peru vote in favor of the deal. Grupo Mexico rejected both the collar and the majority of minority voting conditions and also insisted on 67 million shares. The Special Committee finally agreed to issue 67 million shares for Minera, justifying the additional price by requiring \$100 million in debt reduction for Minera and a proposed Southern Peru special dividend of \$100 million. The Chancery Court notes that by these "bells and whistles," the value of what was being acquired went up and the value of the stock being issued went down.

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One of the independent directors represented a large founding stockholder that wanted to sell its shares of Southern Peru. Part of the terms for the acquisition transaction was the granting of registration rights to that stockholder. This stockholder entered into a voting agreement tying its vote on the merger to the Special Committee's recommended the merger. Another large stockholder entered into an agreement to vote in favor of the merger in exchange for registration rights, however, and this later agreement assured Grupo Mexico that it could potentially achieve the two thirds vote requested even if the Special Committee changed its recommendation, and the director-controlled shares were voted against the merger.

The Special Committee approved the acquisition of Minera for 67.2 million shares, or \$3.08 billion in value. The Goldman analyses presented at the Special Committee meeting at which the transaction was approved were relative value presentations, not stand alone valuations of Minera, and showed a range of Southern Peru shares to be issued under various assumptions for Minera. The analyses used higher multiples than applicable to Southern Peru and attributed these multiples to the privately held, financially troubled Minera. Goldman issued a fairness opinion on the transaction.

Southern Peru's stock appreciated almost 22% between deal announcement and closing (mostly due to increased copper prices). Although the Special Committee had the right to change its recommendation, it did not ask Goldman to issue an updated fairness opinion, despite the fact that Southern Peru had beaten its own EBITDA projections for the current year by 37%, and the Southern

Peru projections on which Goldman's valuation analysis was based had been prepared by Southern Peru management, who were under at least putative control by Grupo Mexico.

Chancery Court Criticism of the Special Committee Process

In ultimately concluding that the transaction was unfair to the minority Southern Peru stockholders, the Chancery Court criticized several aspects of the Special Committee process.

1. *Failure to Act as an Arms' Length Negotiator.* The Chancery Court initially criticized the willingness of the Special Committee to consider the Goldman DCF analysis of Southern Peru showing a significantly lower valuation, as a justification of the acquisition of Minera. One wonders at the Special Committee's reaction to the initial Southern Peru DCF analysis, which showed a lower valuation for Southern Peru than its current market capitalization. Instead of taking issue with the valuation [which had different assumptions than those applied to Minera previously], or expressing concern that Southern Peru's fundamental value was lower than its market value, the Special Committee was "comforted," presumably since this analysis gave it a reason to continue to consider the deal for Minera. The Chancery Court observed that if the valuation of Southern Peru offered by Goldman were credible, a properly motivated Special Committee would have been expected instead to attempt to monetize the asset [its own overpriced stock] for its stockholders, perhaps seeking to sell Southern Peru to Grupo Mexico at a premium to market, perhaps issuing a special dividend. As the Chancery Court observed, the role of a Special Committee in this circumstance is to act "like a third party negotiator with its own money at stake and with the full range of options" available to it. In contrast, the Chancery Court observed that this Special Committee [through its advisors] "began to devalue the "give" [the Southern Peru stock] in order make the "get" [the Minera business] closer in value." Indeed, they were "comforted by the fact that they could devalue that currency and justify paying more for Minera than they originally thought that they should."

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Similarly, at a later point in the negotiations the Special Committee agreed to increase the number of shares being offered from its proposed 64 million to the 67 million shares sought by Grupo Mexico, justifying the additional price by reference to \$100 million in debt reduction required for Minera and a proposed Southern Peru special dividend of \$100 million. The Special Committee itself described these "bells and whistles" [their phrase] as having the effect that "the value of what was being . . . acquired in the merger went up, and the value of the [stock being issued] in the merger went down," giving the Special Committee a reason to accept a higher merger price. Thus, the financial engineering here seems intended to produce a cosmetic fix to accommodate the transaction proposed by Grupo

Mexico, and the record does not reflect an assessment by the Special Committee that the acquisition was the best transaction available to Southern Peru.

2. *Failure to Insist on Right to Negotiate and Right to Consider All Available Alternatives.* Here it is important to note that the fundamental failure may have been the failure to give the Special Committee clear authority to negotiate and to consider all available alternatives to the proposed transaction. Although the Special Committee did in fact negotiate, despite the authority in the resolutions to simply “evaluate” the transaction proposed, the Chancery Court observed that the Special Committee “fell victim to a controlled mindset and allowed Grupo Mexico to dictate the terms and structure of the merger.” The Special Committee’s failure to insist on the right to look at alternatives “took off the table other options that would have generated a real market check and also deprived the Special Committee of negotiating leverage to extract better terms.” The Chancery Court thus noted the Special Committee’s “blinkered approach.” The Chancery Court viewed the Special Committee as “trapped in the controlled mindset where the only options to be considered are those proposed by the controlling stockholder.” Certainly the Special Committee did not seem to think of simply saying no to the acquisition at the time of the initial analysis showing the stark differential in value, nor did the Special Committee pursue any potential alternatives to the transaction at hand. It is worth noting that there were no contemporaneous minutes available - to the extent that the Special Committee did consider other alternatives, this consideration should have been reflected in the minutes and this record might in that case have demonstrated a more independent mindset for the Special Committee.

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3. *Failure to Achieve Collar or Majority of Minority Vote.* A lesser criticism of the Special Committee noted by the Chancery Court was the failure to insist on a collar, which would have required a renegotiation for the fixed exchange ratio deal in the event of a sudden appreciation in the Southern Peru stock, which in fact materialized. Given the volatility of the stock price during the eight months of negotiation, this significant change in the value of the Southern Peru stock could not have been a complete surprise - in fact the Special Committee had not wanted a floating exchange ratio because of the volatility in the stock. Given the wide range of values for Minera generated by Goldman, and this volatility in the Southern Peru stock, one would have thought that a collar might have made some sense on the Southern Peru side. Further, the Chancery Court noted the failure of the Special Committee to insist on a majority of minority voting condition. This failure to insist on a majority of minority condition is particularly notable in light of the registration rights granted to each of two major stockholders. A majority of minority condition does create deal certainty issues, and it may be that minutes of the meetings of the Special Committee could have reflected the Special Committee’s weighing of the costs and benefits of this provision.

4. The Liquidity Interests of A Stockholder Employing One of the Special Committee Members.

As the Chancery Court noted, one of the Special Committee members was employed by a large holder who wanted to be a short term seller. Throughout the negotiations of the merger transaction this stockholder negotiated registration rights allowing it to sell its shares. As noted by the Chancery Court, the Special Committee member employed by this holder did not act consistently with his employer's view - in essence a "short term seller of a company's shares caused that company to be a long term buyer." While the Chancery Court stopped short of calling this interest a conflict arising to a breach of the duty of loyalty, it is clear that this interest influenced one Special Committee member's willingness to agree to the Minera acquisition in exchange for registration rights. Indeed, the Chancery Court observes that this director "was not well-incentivized to take a hard-line position on which terms the Special Committee would be willing to accept" and was tempted to "find a way to make a deal work at a sub-optimal price if that would facilitate liquidity for the stockholding employer." This potential conflict might have been ignored if the Special Committee had shown more independence, but note that the actions by the director here to negotiate the acquisition deal, given his employer's significant countervailing interest in the liquidity offered by registration rights, put the Special Committee at risk for a breach of duty of loyalty claim and consequent removal of the protection of Delaware General Corporation Law Section 102(b)(7) exculpation under the Southern Peru charter.

"All in all, the directors in Southern Peru come away looking at best "less than adroit" and at worst conflicted. Directors will avoid this result by negotiating vigorously at arm's length with their main goal being to act in the best interest of the stockholders (or in a controlled company setting, the minority stockholders.)"

5. Failure to Inform Itself and Permit the Exercise of its Right to Change its Recommendation.

Despite the failure to insist on the majority of minority condition, the Special Committee had in any case negotiated for the right to change its recommendation. If the Special Committee had changed its recommendation, the deal may not receive the stockholder approval required, because the vote of the large stockholder employing one of the Special Committee members was in fact tied to the Committee's recommendation. This right to change a recommendation was a meaningful right, however, only if the Special Committee reviewed its recommendation post-signing. The Chancery Court was clearly disappointed that the Special Committee had evidence that the valuation on which the fairness opinion was based was potentially faulty due to Southern Peru exceeding its EBITDA projections provided by management, but chose not to seek a revised fairness opinion or to otherwise consider a change of recommendation. Thus, although the Special Committee had negotiated for rights that would have permitted it to act to protect its minority stockholders in the very circumstances that arose, it failed to exercise these rights.

Summary of Special Committee Process Defects. The Chancellor sums up the mindset of the Special Committee and its banker as follows: "Throughout the negotiation process the Special

Committee's and Goldman's focus was on finding a way to get the terms of the merger structure proposed by Grupo Mexico to make sense, rather than aggressively testing the assumption that the merger was a good idea in the first place." The Chancery Court finds that the Special Committee attempted "to rationalize doing a deal of the kind the majority stockholder proposed" and agreed to give away over \$3 billion worth of actual cash value "in exchange for something worth demonstrably less, and to do so on terms that by consummation made the value gap even worse, without using any of its contractual leverage to stop the deal or renegotiate its terms." The Chancellor finds that the Special Committee was not "well functioning," and that as a result the burden of persuasion remains upon the defendants.

Lessons for Boards and Special Committees Generally

All boards faced with negotiating a merger can take lessons from the Chancery Court's opinion. Boards and Special Committees should consider the following "take aways"

1. Consider critically the value of the "give" and "get" in a non-cash deal without regard to the other side's negotiating position; focus on the benefit to your stockholders, rather than the other side's proposal on structure and terms as the bottom line basis for negotiations. Act as if this is your own assets.
2. If bankers provide an analysis, and subsequently change the metrics or the premises for the analysis, understand the impact of and reasons for any such changes; similarly if an analysis is subsequently discarded, understand the reasons for the shift to another analysis. Use business judgment to evaluate which analyses give the board or committee the best insights into the valuation and in a non-cash deal, the relative value of the "give" and the "get." Reflect the decisions and the factors considered in those deliberations in the minutes.
3. In the case of a Special Committee, adopt a charter authorizing negotiations, not simply evaluation, with respect to any transaction presented for consideration, and also seek and exercise the right to consider alternatives. Further, regardless of the charter, actually negotiate on behalf of the minority stockholders, and consider all reasonably available alternatives. Keep in mind that it is not necessary that the Special Committee be able to execute on any of the other alternatives, so long as it has the right and obligation to consider them, and also the ability to make recommendations to the full Board with respect to them. The absence of this right may indeed have inadvertently "blinkered" the Special Committee in Southern Peru.
4. Understand and attempt to use negotiating leverage to your advantage. This is particularly important in a controlled company setting, where the Special Committee is called upon to exhibit independence and arms' length bargaining. The process is as important as the outcome. Consider in particular the power to "just say no" to a transaction, and avoid being carried away by deal fever for a particular deal.
5. Consider the economic impact of and practical leverage provided by various deal terms (such as collars, fixed versus floating exchange ratios, change of recommendation). Be aware of changes

in facts that suggest that a change in deal terms is warranted, and use the leverage provided by negotiated deal terms to your advantage throughout the transaction.

6. Avoid having Special Committee or board members with potential or actual conflicts negotiating the deal terms. Make adequate disclosure of all conflicts and discuss ways to mitigate the conflicts if necessary.
7. Where possible, boards and special committees should require that minutes of their meetings be prepared in a timely manner and close in time to the actual meeting. The Chancery Court's analysis was hampered by the lack of minutes and the fact that the minutes had not been prepared close to contemporaneously with the meetings.

All in all, the directors in Southern Peru come away looking at best "less than adroit" and at worst conflicted. Directors will avoid this result by negotiating vigorously at arm's length with their main goal being to act in the best interest of the stockholders (or in a controlled company setting, the minority stockholders.).