Guidelines From Two Important Delaware M&A Cases

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Applying the Entire Fairness Standard, Buyer and its Affiliated Directors Held Liable for $1.263 Billion

Sale Transaction Not Enjoined Even Though Customary Value Enhancement Procedures Not Followed

In the past month, the Delaware Court of Chancery issued two decisions providing important guidance on directors' duties in connection with M&A transactions.

In re Southern Peru S'holder Deriv. Litig.

On October 14, 2011, following a trial on the merits, Chancellor Leo E. Strine, Jr. issued his post-trial decision in the shareholder derivative action in *In re Southern Peru Shareholder Derivative Litigation,* C.A. No. 961-CS. Chancellor Strine awarded **$1.263 billion plus interest in damages** against the acquiror, Grupo Mexico, S.A.B. de C.V. ("Grupo Mexico"). Grupo Mexico was the controlling stockholder of a NYSE-listed company, Southern Peru Copper Corporation ("Southern Peru"). **The individual directors affiliated with Grupo Mexico who served on the Southern Peru board also were held liable.** The lawsuit challenged the acquisition by Southern Peru from Grupo Mexico of a Mexican mining company owned by Grupo Mexico, named Minera Mexico, S.A. de C.V. ("Minera Mexico").

The court succinctly described the transaction proposal as follows: "How about you buy my non-publicly traded Mexican mining company for approximately $3.1 billion of your NYSE stock." Because Grupo Mexico (the buyer) was the controlling shareholder of Southern Peru (the seller), Chancellor Strine concluded that this was a "manifestly unfair transaction" that resulted in Southern Peru substantially overpaying for its acquisition of Minera Mexico, and that as a controlling shareholder, Grupo Mexico breached its duty of loyalty.

Factual and Procedural Background

In February 2004, Grupo Mexico proposed that Southern Peru purchase Grupo Mexico's 99.15 percent stake in Minera Mexico in exchange for 72.3 million shares of newly issued Southern Peru stock, which would be worth approximately $3.05 billion at the time of the offer. At the time, Grupo Mexico owned 54.17 percent of Southern Peru's outstanding stock and 63.08 percent of Southern Peru's voting power, and therefore, Grupo Mexico was the controlling shareholder of Southern Peru.

In response, the Southern Peru board of directors appointed a special committee to assess the proposed transaction. The committee retained its own advisor to assist the committee in assessing the transaction. The special committee and its advisor initially engaged in an "illustrative give/gets analysis," which indicated a $1.4 billion disparity between the value of the Southern Peru stock that would be issued and the value of the asset that would be acquired, a disparity that favored Grupo Mexico. The special

committee and its advisor then abandoned that analysis and, instead, focused on "relative" value metrics reflecting the projected cash flows of the two entities to the combined corporation and similar analyses. The relative value approach allowed the advisor to opine that the transaction was fair, and the special committee then approved the transaction.

Chancellor Strine concluded that, when it appeared that Minera Mexico's value was substantially less than the value of the proposed amount of Southern Peru stock, "the special committee and its financial advisor instead took strenuous efforts to justify a transaction at the level originally demanded" by the control shareholder.

The special committee also agreed to a fixed exchange ratio for the transaction. This was problematic because, after the signing of the definitive agreements but prior to the date the deal closed, the value of the Southern Peru shares to be delivered to Grupo Mexico increased dramatically. This resulted in the value of the stock to be delivered to Grupo Mexico rising to approximately $3.75 billion, again in favor of Grupo Mexico. Even though the special committee had the ability to rescind the deal, the special committee did not do so, it did not seek to alter the transaction in any way, and it did not seek to update the fairness opinion it previously received.

Thereafter, in late 2004, derivative litigation was filed alleging that the transaction was unfair to Southern Peru and its minority shareholders.

The Court's Holdings and Analysis

The court first held, and the parties were in agreement, that entire fairness was the appropriate legal standard of review to be applied where, as here, a controlling shareholder stands on both sides of a transaction, regardless of the existence of the special committee. The defendants therefore had the burden of persuasion. Accordingly, the defendants with the conflicting interests had the burden of demonstrating that the transaction was entirely fair in terms of process ("fair dealing") and price ("fair price") to the other shareholders.

Fair dealing is evaluated, in part, by analyzing the timing of the transaction; how the transaction was structured, negotiated, and disclosed to the directors; and how the approvals of the directors and shareholders were obtained. Fair price is analyzed by reviewing the economic and financial considerations of the transaction, including all relevant factors such as assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of the company's stock and the assets acquired.

Although the use of an effective special committee can shift the burden of proving that a deal was unfair to the plaintiffs, in *Southern Peru* the court concluded that the burden did not shift to the plaintiffs because the special committee was relatively ineffective and because the shareholder vote for the transaction was not conditioned up-front on approval by a majority of disinterested shareholders (i.e., a majority of the minority).

The court concluded that the transaction was not entirely fair to Southern Peru. Because the issues of fair dealing and price were intertwined, the court analyzed both of those elements together. Chancellor Strine found that the special committee and its advisor fell into the all-too-common situation where they

succumbed to the mindset of the controlling shareholder and allowed the controlling shareholder to dictate the terms and structure of the transaction.

Chancellor Strine criticized the special committee's narrow focus: It was formed only to "evaluate" the Grupo Mexico transaction; and its mandate did not allow it to explore alternative transactions. The special committee also failed to understand the market value of the Southern Peru shares to be issued, and it failed to consider changing its affirmative recommendation prior to the shareholder vote based on the post-signing increase in value of Southern Peru's stock. The Chancellor reasoned that the special committee seemed to simply "rationalize one strategic option within the controlled mindset that pervaded the [s]pecial [c]ommittee's process" and went to "strenuous lengths" to equalize the values of Minera Mexico to Southern Peru. The court also questioned whether one member of the special committee was in fact a suitable representative of the minority shareholders' interests, as he simultaneously negotiated registration rights for the large shareholder who had appointed him to the board. As a result, he ultimately abstained from the special committee vote, even though he participated in its process from inception.

Chancellor Strine concluded that there existed a "strange deal dynamic" in which the controlling shareholder, Grupo Mexico, controlled the special committee's mindset and process, as a result of which the committee agreed to a transaction whereby it gave away stock with a significant cash value for something worth demonstrably less. Because the transaction was found to be unfair, Chancellor Strine held that the remaining defendants breached their duties of loyalty.

The court calculated the damages award based on the defendants' breaches of their duty of loyalty. In doing so, Chancellor Strine noted the facts that Southern Peru's stock price has continued to increase, as well as the plaintiff's delay in litigating this case. These facts caused the Chancellor to reject a rescission-based approach to damages, finding that such an approach would be inequitable under these circumstances. Instead, Chancellor Strine awarded damages equal to the approximate difference between the price that would have been paid in an entirely fair transaction and the price actually paid and agreed to by the special committee. Specifically, using the trading value of the shares issued as of closing of $3.672 billion and the court's view that the actual value of Minera Mexico as of closing was only $2.409 billion (based on discounted cash flow, comparable companies' analyses, and a value implied by an initial counteroffer by the special committee), the court determined the damages to be $1.263 billion plus interest, which Grupo Mexico may satisfy by returning Southern Peru shares to Southern Peru.

In re Openlane, Inc. S'holders Litig.

On September 30, Vice Chancellor John W. Noble issued his opinion in *In re Openlane, Inc. Shareholders Litigation,* C.A. No. 6849-VCN. In that opinion, Vice Chancellor Noble denied a motion to enjoin the proposed merger of Openlane, Inc. ("Openlane" or the "Company") with Riley Acquisition, Inc., a wholly owned subsidiary of ADESA, Inc., which is a wholly owned subsidiary of KAR Auction Services, Inc. (collectively, the "Purchasing Entities").

The Vice Chancellor declined to grant injunctive relief even though many of the common efforts undertaken by a board to maximize shareholder value were not utilized by the Openlane board. No auction occurred, no fairness opinion was obtained, no fiduciary out-clause was included in the merger

agreement, and no post-agreement market check was sought. Although the court declined to enjoin the merger, the court was somewhat critical of the process followed. The court stated as follows:

No reason for the absence of these tools has been offered, other than Openlane is a small company, the board was intimately involved with the Company's business and fully familiar with its market economics, and a couple of possible strategic acquirers with whom there had been some dissension did not offer as much.... In sum, although the process could readily have been enhanced and the confidence that value had been maximized, in fact could have been increased, on the whole, a balancing of equities does not tilt toward enjoining the transaction.

The court also observed that the Company is of the few that is actually "managed by" rather than "under the direction of" its board.

Factual and Procedural Background

Openlane is an automotive company that resells formerly leased vehicles. Openlane's board included the Company's CEO and designees from the Company's private equity investors, and the current members of the board and executive officers held beneficial ownership of approximately 68.46 percent of the Company's stock. In April 2010, the board was considering the likely decline in the number of vehicles coming off of lease and its likely impact on the Company's performance. The board expected this decline to be significant and, thereafter, the board engaged a financial advisor to assist it in conducting a strategic sale of the Company.

The financial advisor identified possible strategic and financial buyers, and conducted a market outreach program. The Company then entered into the merger agreement, which followed the "sign-and-consent" model pursuant to which the Company or the buyer could terminate the merger agreement without paying any break-up fee if within 24 hours after the board executed the merger agreement, a majority of Openlane stockholders had not consented to the transaction. The merger agreement also included a non-solicitation clause with no fiduciary-out exception.

The Court's Holdings and Analysis

Applying the standards announced under *Omnicare*, Vice Chancellor Noble allowed the transaction to proceed. In *Omnicare*, the Delaware Supreme Court held that the target's board breached its fiduciary duties by approving a merger agreement that included a so-called "force-the-vote" provision where a majority of the shareholders had already entered into voting agreements. The Delaware Supreme Court reasoned that the deal protection provisions employed in *Omnicare* rendered the merger a *fait accompli* at the moment it was signed.

In *Openlane*, however, Vice Chancellor Noble found that the merger was not a *fait accompli* because when the merger agreement was signed no voting agreements were in place that locked up the requisite shareholder approval. The fact that the shareholder approval in *Openlane* was a "virtual certainty," given the board's (and their affiliate's) and management's 68.46 percent ownership, did not alter the court's view. The Vice Chancellor found it significant that the shareholders were "under no obligation to act in any particular way." Accordingly, the court permitted a 24-hour "sign-and-consent" alternative as not

violating restrictions against a fully locked up merger transaction established in the Delaware Supreme Court's 2003 decision in *Omnicare*.

Vice Chancellor Noble further held that, while *Omnicare* may suggest that a fiduciary-out should be included in all merger agreements, this does not mean that every merger without a fiduciary-out must be enjoined, especially where no superior offer emerged. The Vice Chancellor specifically noted that such a requirement could deprive shareholders of their ability to vote on and approve a deal at hand and that, under the facts of the current case, the board had the ability to terminate the deal if shareholder approval was not delivered by the next business day after signing the merger agreement.

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