Decisions in Delaware Offer Important Guidance for US and Foreign Companies [1]

by Jeffrey R. Wolters

As home to over half of US Fortune 500 companies and thousands of public and private companies worldwide, the State of Delaware plays a major role in US and international M&A transactions. Two recent court decisions offer important practice tips for lawyers who advise US or foreign businesses that are incorporated in Delaware or enter into transactions with companies that are incorporated in Delaware.[2]

Southern Peru. The first decision involved one of the world's largest mining companies, Grupo Mexico.[3] Grupo negotiated a transaction with its majority-owned subsidiary, Southern Peru Copper Corporation, which conducts operations primarily in Peru and Mexico, but is incorporated in Delaware and lists its stock on the New York Stock Exchange.[4] The court determined that the transaction was not fair, and ultimately awarded over $2 billion in damages (including pre-judgment interest) and $300 million in attorneys fees – the largest award in Delaware M&A history.

Synthes. The second decision involved Synthes Inc., a pharmaceutical company which had its headquarters in Switzerland and listed its stock on the SIX Swiss exchange, but was legally incorporated in Delaware.[5] Synthes agreed to sell itself for over $21 billion to Johnson & Johnson (the international healthcare products conglomerate). This time the court upheld the transaction, finding that the Synthes board of directors had done an exemplary job in negotiating the sale and checking the market for other offers.

Lessons from Southern Peru

The *Southern Peru* case involved a fact pattern that is not uncommon in modern M&A: one company owns a majority of another company, and proposes a transaction between the two. Delaware law permits such transactions. However, it also recognizes the inherent conflict of interest, and therefore applies a strict legal test if such a transaction is challenged in court by a minority stockholder of the controlled company. Specifically, the court (typically the Delaware Court of Chancery, which has jurisdiction over such matters) will require both the board of directors of the controlled company and the controlling stockholder to prove that the transaction was "entirely fair" to the minority stockholders of the controlled company. This is a difficult legal test, both because the standard is strict and because the defendants have the burden of proof. The result of failing to satisfy the test can be monetary damages against the directors or the controlling stockholder. Generally, the controlling stockholder faces this risk of potential liability even if it has no ties to Delaware other than its ownership of the controlled company.

Application of the Fairness Test

In the *Southern Peru* case, Grupo Mexico owned a majority of Southern Peru's stock, and also owned over 90% of another mining company. Grupo proposed that Southern Peru buy this other company from Grupo for over $3 billion. The price was to be paid in NYSE-listed shares of Southern Peru. Because Grupo controlled Southern Peru, the transaction, if challenged in court, would be subject to the entire fairness test under Delaware law.

Upon receiving the proposal from Grupo, the Southern Peru board responded as is typical in such situations: it formed a committee of independent directors to consider the proposal. Use of a committee can help satisfy the entire fairness test. It can also, if it functions properly, relieve the defendants of the burden of proof (i.e., the plaintiff would have to prove a lack of entire fairness, rather than the defendants having to affirmatively establish entire fairness).

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2 The trial judge in both cases was Chancellor Leo E. Strine, Jr., the head of Delaware's Court of Chancery, which has been described by the New York Times as "the most important legal battleground for American corporations." Michael J. De La Merced, *Strine Nominated for Top Job at Delaware Chancery Court*, N.Y. Times, June 8, 2011.

3 *In re Southern Peru Copper Corporation Shareholder Derivative Litigation*, 30 A.3d 60 (Del. Ch. 2011), *aff'd*, Del. Supr., No. 29, 2012 (Aug. 27, 2012).

4 The corporation 11 is known today as Southern Copper Corporation, and has a market capitalization of over $30 billion.

5 *In re Synthes, Inc. Shareholder Litigation*, C.A. No. 6452, Strine, C. (Del. Ch. Aug. 17, 2012).

The committee ultimately approved Grupo's proposal with few changes. A minority stockholder of Southern Peru then brought suit in the Delaware Court of Chancery, alleging that the transaction was not fair and that therefore both Grupo and the Southern Peru directors were liable in damages. Chancellor Strine agreed, finding after trial that the committee had not functioned properly, and that the price paid by Southern Peru to Grupo was excessive – indeed, that it was approximately $1.3 billion too high, which increased to $2 billion when pre-judgment interest was added. The court ordered that this amount be returned by Grupo to Southern Peru.

The Court's Determination that the Transaction Was Not Fair

In finding that the transaction was not fair, the court was especially critical of several aspects of the sale process, including:

- The board committee of Southern Peru had not investigated alternative transactions, such as the possibility of selling Southern Peru.
- The committee, although advised by premier legal and financial advisors, did not appear to have bargained aggressively with Grupo, but rather seemed to have worked in a "controlled mindset" to justify the deal as proposed by Grupo.
- The committee included one director whose complete independence from Grupo was questionable, since that director was the representative of a large stockholder that was seeking registration rights for its shares from Southern Peru, decision that was effectively controlled by Grupo as majority stockholder.
- The committee did not get a "bring down" fairness opinion from its investment banker as to the fairness of the transaction price.

Overall, the court was most concerned with what it saw as a failure by the Southern Peru board committee to negotiate down the transaction price, particularly when the discounted cash flow valuation analysis of its own investment banker indicated that the deal price was excessive.

Practice Tips from *Southern Peru*

The following practice tips can be gleaned from the decision:

- Independent counsel to a board committee should focus on the composition, authority and conduct of the committee:
  - Composition: question committee members concerning potential conflicts, including liquidity interests and ties that may exist due to other business or social relationships. Such conflicts will not necessarily disqualify a director from service on the committee, but it is important that they be fully disclosed to and considered by the other committee members.
  - Authority: generally, a committee should be given the full authority of the board with respect to the matter at hand, including the authority to consider alternative courses of action; however, certain decisions, such as final approval of a merger agreement, can only be made by the full board under Delaware law.
  - Conduct: ensure that the committee bargains independently and at arm's length with the controlling stockholder, and builds a record (including minutes) demonstrating such conduct. In *Southern Peru*, the court was concerned about the committee's lack of vigor and apparent "controlled mindset."
- Independent counsel should also focus closely on the inputs that the committee receives from its financial advisor, including:
  - Valuation analysis, particularly discounted cash flow, which the court viewed as the main metric of actual value in *Southern Peru*.
  - Advice concerning the feasibility and attractiveness of alternative courses of action.
  - Fairness opinion and "bring down" fairness opinion if time has passed.
- Independent counsel should also take care to question the independent committee's financial advisor closely concerning potential conflicts of interest, including:
  - Economic interest of the firm, as well as its individual bankers on the assignment, in the other party to the transaction.
  - Any financing interest that the firm may have on the "buy side" of the deal, which Delaware judges have generally criticized as inappropriate where the firm is advising the seller.

The Synthes Decision

While *Southern Peru* is helpful to M&A practitioners as a road map of conduct to avoid, the *Synthes* decision is helpful as a road map of conduct to follow. Synthes, Inc. was a global medical device company incorporated in Delaware

with its headquarters in Switzerland. Over 50% of its stock was owned or controlled by its Swiss chairman. In 2011, Synthes agreed to a merger with Johnson & Johnson, as a result of which Synthes's stockholders would receive approximately $21 billion, to be paid 65% in J&J stock and 35% in cash.

When the deal was announced, a minority stockholder of Synthes brought suit in Delaware against the Synthes board of directors and its chairman, arguing that they had violated their fiduciary duties by agreeing to the deal. In particular, the stockholder alleged that a higher price could have been obtained from another buyer if the chairman, as controlling stockholder, had agreed with this buyer's proposal that the chairman "roll over" some of his stock (that is, remain a partial investor in the company even after the acquisition). The stockholder also argued that it was a breach of duty not to conduct a more extensive "market check" for other potential buyers.

The court emphatically rejected these claims, granting a motion to dismiss in favor of the defendants.

Legal Analysis in *Synthes*

As in *Southern Peru*, the case involved a controlling stockholder. Unlike *Southern Peru*, however, the controlling stockholder in *Synthes* did not "stand on both sides" of the transaction. Instead, the controlling stockholder was simply receiving for his shares the same price that was to be received by all other stockholders. Chancellor Strine ruled that such equal treatment was a "form of safe harbor" under Delaware law, and that therefore the transaction was protected by the business judgment rule. The business judgment rule is Delaware's most lenient legal standard. As a practical matter, when it applies, directors and controlling stockholders are protected from liability.

In dismissing the complaint, the court made two important rulings:

- First, it distinguished certain prior "bad facts" cases where controlling stockholders have been found potentially liable despite receiving the same price for their shares as all stockholders in a merger.
- Second, it held that Delaware's *Revlon* standard of review did not apply.[6] *Revlon* requires a board to show that it acted reasonably to obtain the highest price available in the market before approving a sale of the company. The test generally applies whenever a company is sold for cash. However, the Chancellor held that *Revlon* did not apply when 65% of the transaction consideration received by target stockholders was comprised of publicly traded stock of the acquiring company.

Practice Tips from *Synthes*

Counsel in *Synthes* built a record establishing several points that helped protect the transaction, including:

- The proxy statement made clear that the board as a whole, and not the controlling stockholder, actively led the sale process.[7]
- The board had solicited and considered other bids.
- There was no indication that the controlling stockholder faced a particular need for liquidity, or that the transaction was designed to satisfy his desire for liquidity as opposed to maximizing value for all stockholders.
- It was also clear that the only potentially higher offer for the company was from a consortium that insisted that the controlling stockholder retain a significant equity stake, i.e., that he be treated differently from other stockholders.
- Finally, the board and its legal and financial advisors built a strong record, as demonstrated in the course of negotiations and documented in the proxy statement, that the board had negotiated aggressively to increase the price paid by J&J and did not simply accept a first offer.

Thus, while the different outcomes in *Synthes* and *Southern Peru* resulted largely from differences in the two transactions, the conduct of the directors – and the record of that conduct built by counsel – was a crucial factor in both cases.

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6 *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).*).

7 Because the complaint quoted from the proxy statement from the transaction, the court relied on factual statements from the proxy statement in reaching its decision.