

\$1.26 Billion Damage Award Highlights Gulf Between Delaware and Canadian Scrutiny of Special Committees

By: [Iain Scott](#)

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In the recent Delaware decision of *In Re Southern Peru Copper Corporation*, Chancellor Strine awarded an eye-popping \$1.26 billion in damages against a corporate controlling shareholder and its nominee directors in a related-party merger transaction, because the special committee's efforts to secure a good deal for minority shareholders were found to be lacking.

Consideration of how this case might be dealt with in Canada, including a contrast with the recent Magna International proceedings in Canada, reveals some significant differences between the two regimes and some useful take-away points.

In Re Southern Peru Copper

Chancellor Strine's opening words in the opinion captured the situation well, "The controlling stockholder of an NYSE-listed mining company came to the corporation's independent directors with a proposition. How about you buy my non-publicly traded Mexican mining company for approximately \$3.1 billion of your NYSE-listed stock? A special committee was set up to "evaluate" this proposal and it retained well-respected legal and financial advisors."

The transaction had many of the bells and whistles of a well-managed transaction: a special committee of directors was established, all of the members were independent, top-tier financial and legal advisors were retained, the special committee met many times over a period of eight months, the special committee succeeded in negotiating a number of points, a fairness opinion was obtained, and the transaction was conditioned on a super-majority vote (although not a majority of the minority vote). When the transaction was put to a vote, over 90 per cent of shareholders voted in favour.

So what went wrong? In short, Chancellor Strine found that the negotiation by the Special Committee was not "effective," that "from inception, the Special Committee fell victim to a controlled mindset and allowed the [controlling shareholder] to dictate the terms and structure of the merger." Chancellor Strine pointed to a number of problems that reflected this underlying "mindset" issue:

- The Special Committee's mandate was narrowly defined to "evaluate" the transaction, not to negotiate it. As a result, "its approach to negotiations was stilted and influenced by its uncertainty about whether it was actually empowered to negotiate."
- The Special Committee failed to explore alternatives. It was "trapped in a controlled mindset where the only options to be considered are those proposed by the controlling shareholder." Chancellor Strine continued, "Even if the practical reality is that the controlling shareholder has the power to reject any alternate proposal it does not support, the special committee still benefits from a full exploration of its options."
- The financial advisor to the Special Committee ignored valuation metrics that did not support the price proposed by the controlling shareholder and instead, focused on rationalizing the transaction proposed by the controlling shareholder, rather than aggressively testing the assumption that the transaction was a good idea in the first place.
- The special committee and the financial advisor failed to re-evaluate the fairness of the transaction after announcement and prior to the shareholder vote, even though in the meantime the economics of the transaction had significantly worsened.

The court made a damage award against the controlling shareholder and its nominee directors on the company's board, effectively requiring the controlling shareholder to pay back to the company the difference between the price that it had received and the price that would have been paid in an entirely fair transaction, as determined by the court. The members of the special committee would also have been held liable but for the fact that the corporate charter included an exculpatory provision, as is permitted under Delaware law.

Chancellor Strine's ruling was based on the application of the "entire fairness" standard of review: in a transaction where a controlling shareholder effectively stands on both sides, the parties with a conflicting interest must demonstrate "their utmost good faith and the most scrupulous inherent fairness of the bargain." This requires that both the process and the price be fair. The fact that shareholders vote in favour of the transaction is not relevant, although in certain circumstances a properly informed, pre-conditioned majority of the minority vote can shift the burden of establishing entire fairness (or the lack thereof) to the other party. In this case, the fact that over 90 per cent of shareholders had voted in favour, did not shift the burden, if only because the transaction was not pre-conditioned on a majority of the minority vote and the public disclosure in the proxy circular was found to be misleading. Yet Chancellor Strine stated that he would have reached the same conclusion regardless of which party had the burden.

While the Delaware courts may not in every entire fairness case be in a position to substitute their own determination of value for that reached by the parties as Chancellor Strine did in this case, this decision nonetheless demonstrates the high level of scrutiny that the Delaware courts will give to the special committee process and outcome in related-party transactions.

The Canadian Context

So how would this transaction have played out in Canada?

There are a number of significant differences between the Canadian legal regime and that in Delaware which affect the level of scrutiny to which a special committee will be subject in this type of transaction.

First, in Canada, controlling shareholders do not owe fiduciary duties to minority shareholders and transactions involving controlling shareholders are not subject to an entire fairness standard of review akin to that in Delaware. Instead, minority shareholders with complaints about the conduct of a controlling shareholder or a board of directors in a related-party transaction will generally seek relief under the statutory oppression remedy. The oppression remedy, among other things, gives the courts broad powers to remedy conduct of a controlling shareholder or board of directors that has been found to be "oppressive, unfairly prejudicial" or to "unfairly disregard" the interests of a minority shareholder. While the application of the oppression remedy can give rise to fiduciary-like constraints on controlling shareholders, it imposes two significant hurdles on complainants which sharply distinguish it from the entire fairness standard of review:

- The complaining party always has the burden of establishing that there was oppressive conduct, rather than the initial burden being on the controlling shareholder to justify the fairness of the transaction, as is the case under the entire fairness review.
- Even where a controlling shareholder is involved, the Canadian courts will still generally apply the business judgment rule and give deference to the decisions of the directors. As the court put it in *Stronach v. Greenlight Capital*, "the court only requires that the directors make a decision which is in a range of reasonableness and the courts will not interfere with the selection by the directors of one of several reasonable alternatives."

Second, in one of the few contexts where the Canadian courts are prepared to engage in a direct examination of the substantive fairness of a deal without any deference to the directors, namely a

fairness hearing to approve a plan of arrangement (which is a common method of implementing M&A transactions in Canada), the courts will "focus on the terms and impact of the arrangement itself, rather than the process by which it was reached," as the Supreme Court of Canada stated in the leading case of *BCE Inc. v. 1976 Debenture Holders*. Under the entire fairness standard in Delaware, by way of contrast, the fairness of the process will be closely scrutinized as well as the fairness of the outcome.

Third, in addition to review by the courts, related-party transactions in Canada are subject to regulation by the securities regulators, primarily through a codified set of rules that specify procedural safeguards (e.g., special committee of independent directors, formal valuation, or majority of minority vote) that must be implemented in various circumstances. While these requirements impose significant constraints on the conduct of related party transactions, it is rare for the securities regulators to go beyond the rules and examine how the process was actually conducted in any particular case, and where they do, the situation must be egregious before they will intervene on these grounds alone.

Due to the judicial deference shown by the Canadian courts under the business judgement rule, along with the rules-based approach to regulation by the securities regulators, it is rare that the substantive effectiveness of a special committee process, in any particular case, will ever be subjected to Strine-level scrutiny by the courts or the securities regulators. This tends to favour a check-the-box procedural approach to compliance in many related-party transactions in Canada.

Magna International Proceedings

A graphic illustration of these differences is provided by the Magna International transaction which occupied the Ontario Securities Commission (OSC), the Ontario courts and the Canadian business press last summer. In that transaction, a special committee of independent directors approved the submission to shareholders — albeit without a recommendation as to how shareholders should vote and without obtaining a fairness opinion — a transaction whereby a controlling shareholder would receive approximately \$1 billion in cash and shares in return for surrendering his multiple voting shares, thereby eliminating his control of the company and collapsing the company's dual-class share structure. The sheer size of the payment to the controlling shareholder, which was vastly in excess of that any paid in any comparable precedent transaction, caused an outcry and strong opposition from large Canadian institutional investors, and prompted the staff of the Ontario Securities Commission to initiate proceedings to block the transaction on public interest grounds.

Like *In Re Southern Peru Copper*, Magna had many of the bells and whistles of a well-managed transaction: a special committee was established, the members were independent, top-tier financial and legal advisors were retained, the committee met many times and managed to negotiate some minor concessions, and the transaction was conditioned on a majority of the minority vote. When it came to a vote, 75 per cent of the disinterested minority shareholders voted in favour.

While the Commission decided not to block the transaction, in its reasons released months after the transaction was consummated, it identified serious concerns with the special committee process, ones which were remarkably similar to those identified by Chancellor Strine in *In Re Peru Copper*. The Commission stated, "In our view, the Special Committee's mandate and terms of reference were, in the circumstances, fundamentally flawed." The Commission made the following specific findings:

- The Magna Special Committee's mandate was limited to considering only the proposal that had been developed by the controlling shareholder with management (which had a fundamental conflict of interest).

- The Magna Special Committee's mandate was only to review and consider the terms of the proposal, not to negotiate it, although it did in fact go beyond it and engage in some negotiation.
- By its mandate, the Magna Special Committee was only to consider whether the transaction should be presented to shareholders but not whether it was fair to shareholders.
- The entire Magna Special Committee process was tainted by the involvement of executive management from the beginning of and during the process.

The Commission concluded that while it considered blocking the transaction on this basis, ultimately it felt it did not have sufficient evidence before it as to the actual process and deliberations to justify intervening on these grounds alone. It did, however, order very significant revisions to the proxy circular which it found did not contain sufficient information to allow the shareholders to make an informed decision as to how to vote on the proposed transaction, and in some cases was materially misleading.

As the transaction was implemented by way of plan of arrangement, the parties next proceeded to a fairness hearing before the Ontario Superior Court. Relying heavily on the fact that 75 per cent of the disinterested minority shareholders had voted in favour of the transaction, the court found that the arrangement was "fair and reasonable." The concerns regarding the special committee process identified by the OSC, however, were not considered as part of its analysis.

The shareholder vote played a very significant role in the Magna. The transaction was conditioned up-front on a majority of the minority vote, and the vote was taken with the benefit of enhanced, gold-plated disclosure that was pre-approved by the OSC. With 75 per cent of the minority shareholders voting in favour of the transaction in such circumstances, it was difficult for the court to say that it was "unfair." *In Re Southern Peru Copper*, on the other hand, the vote clearly did not carry the same weight, if only because the transaction was not conditioned up front on a majority of the minority vote and the disclosure in the proxy circular was found by Chancellor Strine to be materially misleading.

Perhaps if the opposing parties in Magna had brought an action for oppression or breach of directors' duties, more attention would have been paid to the special committee process, but it is not clear that the result would have been any different. What can be said is that in one of the most litigated transactions in recent Canadian memory, even though there were clear indications that the Special Committee had succumbed to the "controlled mindset" described by Chancellor Strine, the transaction still proceeded on the terms initially agreed to by the controlling shareholder, with the blessing of the courts and the securities regulators.

While the various differences between the Delaware and Canadian legal contexts make direct comparison challenging, the bottom line is that a Strine-level scrutiny of the effectiveness of a special committee is much less likely to occur in Canada than in Delaware. Even more remote is the possibility under Canadian law of a large damage award against a controlling shareholder just because a special committee, which respected all of the check-the-box formalities, did not negotiate hard enough with the controlling shareholder. Canada is a good place to be a controlling shareholder.

Take Away Points

This does not mean that practitioners in Canada should simply disregard *In Re Peru Southern Copper*. Despite the differences between the Canadian legal regime and that in Delaware, the process followed by special committees still matters, particularly where the decisions of directors may be challenged under the oppression remedy. Chancellor Strine's opinion, together with the concerns relating to the special committee process raised by the OSC in Magna, provide some useful lessons, or at least reminders, for practitioners that travel well across borders:

- Serious attention needs to be paid to the definition of the mandate of the special committee. If it is unduly or arbitrarily limited, it may compromise the entire process. The ability of the special committee to explore alternatives, to negotiate directly with the other party and to assess the fairness and advisability of the transaction may be seen in retrospect as essential to the proper performance of its role.
- The examination of alternatives is often critical to the proper performance of a special committee's function. While there is no requirement for a special committee to consider every possible alternative, it must avoid falling into the "controlled mindset" described by Chancellor Strine. Fairness is difficult to assess in the abstract, rather it must be assessed in the context of the available alternatives. Even where a controlling shareholder may be able to block such alternatives, the diligent exploration of those alternatives itself can still often reveal a lot about value and the position and views of the other party, and provide a more robust basis on which to assess fairness.
- Instead of just relying on the fact that a fairness opinion is being given, directors must understand the approach to valuation and scope of enquiry underlying the fairness opinion, and confirm that they are congruent with and support the proper performance of the special committee's own mandate. To the extent they are not, the fairness opinion may provide little protection. For their part, financial advisors need to consider carefully what they need to do to support the special committee in the proper performance of its function.
- At least in the Canadian context, as Magna so clearly demonstrated, a pre-conditioned and well-informed majority of the minority vote can sustain a transaction that might otherwise be challenged on grounds of procedural deficiencies or other objections of unfairness.