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PROCESS IS PARAMOUNT: THE DELAWARE COURT OF CHANCERY GIVES "100% WEIGHT" TO MERGER PRICE IN DETERMINING COMPANY'S FAIR VALUE IN APPRAISAL PROCEEDING

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On December 16, 2016, the Delaware Court of Chancery issued a post-trial opinion in an appraisal proceeding arising from the acquisition of Lender

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Processing Services, Inc. ("LPS" or the "Company") by Fidelity National Financial, Inc. ("Fidelity"). In his opinion in *Merion Capital LP et al v. Lender Processing Services Inc.*,[1] Vice Chancellor Laster held that the "fair value" of the Company's stock at the effective time of the merger was the $37.14/share merger price. *LPS* is just the latest of several relatively recent decisions equating fair value and merger consideration where the merger was the product of an appropriate sale process consisting of, among other things, an arm's-length negotiation conducted by an independent and informed board advised by independent financial advisors. Delaware courts have been equally clear, however, that they will not accord such weight to the merger price in determining a company's fair value where the transaction is not the product of such a properly conducted sale process. The decision reinforces the importance that a board and management implement in advance a vigorous and conflict-free process for selling a company in order to defeat shareholder appraisal or fiduciary duty challenges.

Background

LPS was a provider of integrated technology products, data and services to the mortgage lending industry. It was spun off as a separate public company by Fidelity in 2008. "Because of the Company's historic ties to Fidelity, the Company continued to share an office campus with its former parent (although occupying separate buildings). The two companies also shared private jets, hangar facilities and server space."

In April 2010 and again in early 2011, a consortium consisting of Fidelity, Thomas H. Lee Partners ("THL") and Blackstone Group approached LPS with an interest in acquiring the Company. The Board of Directors (the "Board") retained an outside financial advisor, but no deal was reached at that time. The consortium next made an all-cash offer to acquire LPS for $26.50/share in February 2012, but the Board "decided to explore whether someone might pay more by reaching out to other financial sponsors and strategic buyers." In May 2012, the Board's financial advisor contacted three financial sponsors and seven potential strategic buyers but no offer was made. Meanwhile, following due diligence, the Fidelity consortium had increased its offer to $29/share payable either all in cash or $27/share cash plus $2/share in Fidelity stock. "The directors felt that was a good price but remained committed to $30.00/share."

In October 2012, the Board hired Boston Consulting Group ("BCG") to evaluate the Company and its strategic alternatives. "BCG would spend the next six months conducting an in-depth review of the Company's business that included over 120 interviews with LPS employees, customers, and investors." Then, on January 31, 2013, LPS announced that it had entered into a settlement agreement with attorneys general from forty-six states and the District of Columbia, a non-prosecution agreement with the Department of Justice, and a settlement of shareholder litigation in connection with "robo-signing" allegations. In the weeks following the settlements, LPS received at least six unsolicited expressions of interest in an acquisition, including from Fidelity, which offered $30/share through a combination of cash and stock.

Given the increased interest in a potential acquisition, the Board hired a second financial advisor but decided to defer consideration of any offers until after BCG completed its review. BCG presented its findings at a March 21, 2013 Board meeting, at the end of which, on the recommendation of both financial advisors and BCG, with management concurring, the Board determined to solicit offers for the sale of the Company.

On May 27, 2013, after soliciting bids from strategic and financial buyers, the Company entered into a merger agreement with Fidelity for consideration valued at $33.25/share (the "Initial Merger Consideration") paid 50% in cash and 50% in Fidelity stock. Both financial advisors issued fairness opinions and

Institutional Shareholder Services and Glass Lewis & Co. recommended that shareholders vote in favor of the transaction. Ultimately 78.6% of all stockholders, and 98.4% of those voting, cast votes to approve the transaction.

The merger closed on December 19, 2013 at a value of $37.14 per share (the "Final Merger Consideration"),[2] representing a 28% premium to the Company's unaffected market price on the last trading day before media reported on merger discussions.

Merion Capital L.P. and Merion Capital II L.P. demanded an appraisal of their shares, which they valued at $50.46 per share. The Court held that "the evidence at trial established that the Final Merger Consideration was a reliable indicator of fair value as of the closing of the Merger and that, because of synergies and a post-signing decline in the Company's performance, the fair value of the Company as of the closing date did not exceed the final deal price of $37.14 per share."

The Court gave "100% weight to the transaction price" because LPS "ran a sale process that generated reliable evidence of fair value" and "created a reliable set of projections that support a meaningful" discounted cash flow ("DCF") analysis. The Court's DCF valuation was "within 3%" of the final deal price.

Takeaways and Analysis

Merger price alone is not determinative, but can be reliable evidence of, fair value in appropriate circumstances. While the Court ultimately concluded that the fair value of the Company was the Final Merger Consideration, it cautioned that Delaware courts have "eschewed market fundamentalism by making clear that market price data is neither conclusively determinative of nor presumptively equivalent to fair value."[3] Rather, if the "merger giving rise to appraisal rights 'resulted from an arm's-length process between two independent parties, and if no structural impediments existed that might materially distort the crucible of objective market reality,' then 'a reviewing court should give substantial evidentiary weight to the merger price as an indicator of fair value.' "[4] In other words, according to the Court, in "evaluating the persuasiveness of the deal price, this court has cautioned that '[t]he dependability of a transaction price is only as strong as the process by which it was negotiated.' "[5]

A determination that the merger consideration is reliable evidence of fair value depends on the quality of the sale process. The Court of Chancery found that the Board's sale process led to a merger price that was reliable evidence of the Company's fair value. In reaching this conclusion, the Court stated, among other things, that:

- **There was "meaningful competition among multiple bidders during the pre-signing phase."** The Court discussed the importance of creating at the outset an auction process that fosters actual or perceived competition among diverse potential bidders. Adding competition "at the front end" tends to yield significantly more value than back-end negotiations. And, by soliciting "heterogeneous bidders" (typically strategic buyers as opposed to just financial buyers, all of whom tend to use the same valuation models and techniques to arrive at largely similar valuations), a selling board is more likely to achieve a price that fully values the company.

Here, LPS's Board "conducted a sale process that involved a reasonable number of participants and created credible competition among heterogeneous bidders during the pre-signing phase." The process began with unsolicited bids from three strategic buyers and two financial sponsors, and the Board's financial advisors then solicited three additional strategic buyers. The Board's financial advisors "approached all of the potential bidders on equal terms, and all knew that the Board was conducting a sale process and so faced the prospect of competition when formulating their offers."

- **The threat of competition can be as effective as actual competition.** The Court rejected an argument from Merion that the auction failed to generate competition because a significant potential strategic buyer decided not to bid. According to the Court, Fidelity did not know during the pre-signing phase that this potential bidder had dropped out—it only knew that the Company was conducting a sale process with multiple parties and that the merger agreement likely would have a post-signing go-shop period, which could "create a path" for competition in the pre-closing period. The Board's rejection of overtures from Fidelity in 2010, 2011 and 2012 "[r]einforc[ed] the threat of competition."

The Court cautioned that it was not suggesting any legal requirement to engage with multiple bidders. Nor is doing so a prerequisite to a finding that merger price constitutes reliable evidence of fair value. Rather, the fact that the Board created a process that engaged multiple bidders rendered its argument for reliance on deal price "more persuasive."

- **Adequate and reliable information about LPS was equally available to all participants throughout the sale process.** The Court observed that reliable information may be unavailable for any number of reasons, including regulatory uncertainty or a decision to provide different information to each bidder (providing favored bidders with greater or more accurate information as a "subsidy"). Here, all bidders had equal access to company information and the opportunity to conduct due diligence, and the Company resolved its significant regulatory inquiries prior to conducting the auction. As a result, there was no persuasive evidence undermining the reliability of information provided to bidders.

- **Management and the Board did not exhibit favoritism toward certain bidders and were incentivized to maximize the merger consideration.** The Court observed that a "common risk in corporate sale processes" is that management will favor a particular bidder "for self-interested reasons," even if doing so does not rise to the level of a breach of fiduciary duty. Here, LPS's management believed that Fidelity would not retain them and so had a reason not to favor the winning bidder.

Merion pointed to ties among Fidelity, THL and certain LPS directors as a reason to call into question the sale process. Specifically, the Company's CEO had consulted for and managed Fidelity from 2002-2006; an outside LPS director served as an officer of one of THL's portfolio companies; and LPS's Chairman served as CEO of Fidelity from 2006-2009. Fidelity and LPS also shared an office campus and certain assets. The Court concluded that these relationships did not undermine the sales process because, among other things: (i) the CEO and outside director recused themselves from deliberating as directors during the sale process; (ii) LPS's Chairman participated only after disclosure to the Board; and (iii) all members of the Board and management were net sellers and collectively expected to receive approximately $100 million from the merger in stock-based compensation, thereby giving them a strong incentive to maximize the merger price.

The conflicts of interest inherent in a management buy-out potentially render the acquisition price less reliable as evidence of fair value than in other transaction contexts. The Court observed that a claim that the merger consideration in an MBO represents fair value "should be evaluated with greater thoroughness and care than, at the other end of the spectrum, a transaction with a strategic buyer in which management will not be retained."[6] Management could, for instance, by virtue of its position have nonpublic information about the company and use this "informational asymmetry" to time the MBO at "advantageous times in the business cycle or history of the corporation."[7] Vice Chancellor Laster's decision[8] in the Dell management buy-out appraisal proceeding explores this issue in more detail, but there he found that notwithstanding evidence of an active market check, the consideration paid by the Michael Dell-led management group did not reflect fair value, including because "the transaction was not subject to meaningful pre-signing competition."

Courts need to consider evidence of changes in company value in the post-signing period given that an appraisal measures fair value at closing. Seven months elapsed between the time LPS signed the merger agreement and closing. In that time, the merger consideration increased due to an increase in the price of Fidelity's stock and LPS's performance deteriorated, suggesting that the fair value of the Company did not exceed the merger price.

The absence of a topping bid in a go-shop period is not necessarily evidence that the merger consideration represents fair value. The Court found that several factors "undermined the efficacy of the go-shop:"

- The go-shop was not part of the financial advisors' plans for the sale process, and they provided no advice on timing or structure of a go-shop. In addition, there was evidence that the parties retained a go-shop in order to mitigate litigation risk. To the Court, the go-shop "appears to have been a lawyer-driven add-on."
- The Court also viewed the "quality of the contacts" during the go-shop as "suspect." While the Board's financial advisors contacted twenty-five potential strategic buyers and seventeen potential financial buyers, the "bulk" of those companies "already had demonstrated that they were not interested in acquiring the Company" or had been ruled out as "unlikely transaction partners."
- The merger agreement granted Fidelity an "unlimited match[] right" with respect to offers made during the go-shop, which likely was a "sufficient deterrent to prevent other parties from perceiving a realistic path to success" in a bidding war. This concern was particularly acute here given that Fidelity could achieve synergies by acquiring LPS and therefore would likely be able to outbid any competitor that lacked similar access to synergies or a way to value them.

Undisclosed financial advisor conflicts can, but do not always, undermine the integrity of the sale process. The Court observed that the proxy statement revealed that one financial advisor "had a lucrative relationship with THL that generated $97 million during the previous two years," which had not been disclosed to the Board or management prior to the proxy filing. The second financial advisor received $26 million from THL in the previous two years, which also was not disclosed until the proxy filing.

The Court did not address the consequences of these undisclosed relationships between the financial advisors and the winning bidder in its opinion, let alone consider these facts as a basis to call into question the integrity of the sale process. The Court's decision not to address this issue is somewhat surprising given the Court of Chancery's focus on financial advisor conflicts over the past few years.

There are a number of possible explanations. One is that in this particular case, there was very strong evidence of a disinterested and independent Board actively engaged in a vigorous sale process with no disabling conflicts, rendering the financial advisors' relationship with THL immaterial. Relatedly, there was no evidence cited that the financial advisors actually did anything to compromise the sale process in a way to benefit Fidelity and THL. And, the Company's stockholders voted overwhelmingly to approve the deal after disclosure in the proxy statement of the financial advisors' relationships with THL.

Nonetheless, it is important to remember the Court's repeated admonitions over the past several years that directors must investigate and uncover potential conflicts of interest on the part of their financial advisors, and to do otherwise risks that a court will not credit the integrity of the seller's process.[9]

Evidence that the merger consideration includes a portion of the value the acquirer expects to achieve in post-closing synergies can support merger price as representative of fair value. The Court cited "extensive evidence" that the Initial Merger Consideration included a portion of the synergies that Fidelity expected the merger to yield. The Final Merger Consideration likely incorporated an additional portion of this value by virtue of the component consisting of Fidelity stock. This provided an additional reason to conclude that the Final Merger Consideration exceeded the fair value of the Company.

The focus and quality of the parties' arguments can impact the Court's assessment of the reliability

of merger price as evidence of fair value. In discussing how courts assess whether the agreed-upon merger consideration is reliable evidence of fair value, Vice Chancellor Laster pointed to a perhaps "underappreciated aspect of appraisal jurisprudence." He observed that because an appraisal decision results from an adversarial litigation process, "the issues that the court considers and the outcome that it reaches depend in large part on the arguments that the advocates make and the evidence they present." An argument may "carry the day" in one case but not another depending on whether "counsel advance it skillfully and present persuasive evidence to support it."

While not directly tying these observations to this case, the Court did note in its opinion approaches that the parties might have but did not undertake. For instance, the Court found that the post-signing increase in Fidelity's stock price and deterioration in LPS's financial performance was supportive of the Final Merger Consideration representing evidence of fair value. The Court observed that Merion "might have sought to address these issues," including by showing "by reference to other companies or indices that but for the [m]erger, the Company's stock price would have risen as well;" or they might have sought to show that declines in LPS's performance "resulted from the [m]erger itself and therefore should be excluded as a valuation consideration." Instead, Merion argued that the Company's post-signing performance did not require any adjustment to management projections, which suggested that the going concern value "did not change."

ENDNOTES:

[1]C.A. No. 9320-VCL (Del. Ch. Dec. 16, 2016).

[2]The Merger Agreement included a one-way collar that would provide protection against a decline in Fidelity's stock price of more than 5%. At the date of closing, Fidelity's stock price had increased, resulting in an increase in the merger consideration. Fidelity "elected twice to increase the cash component, which ended up at $28.10 per share. The collar yielded a stock component valued at $9.04 per share. The aggregate merger consideration received by the Company's stockholders at closing was $37.14 per share."

[3]Citing *In re Appraisal of Dell Inc.(Dell Fair Value)*, No. CV 9322-VCL, 2016 WL 3186538, at *22 (Del. Ch. May 31, 2016), *reargument denied*, (Del. Ch. June 16, 2016).

[4]Citing *Highfields Capital, Inc. v. AXA Fin., Inc.*, 939 A.2d 34, 42 (Del. Ch. 2007).

[5]Citing *Merlin Partners LP v. AutoInfo, Inc.*, No. CV 8509-VCN, 2015 WL 2069417, at *11 (Del. Ch. Apr. 30, 2015), judgment entered, (Del. Ch. May 8, 2015).

[6]Citing *Dell Fair Value*, 2016 WL 3186538, at *28.

[7]Citing Matthew D. Cain & Steven M. Davidoff, *Form over Substance? The Value of Corporate Process and Management Buy-Outs*, 36 Del. J. Corp. L. 849 (2011).

[8] http://courts.delaware.gov/Opinions/Download.aspx?id=241590.

[9]*See, e.g., In re: El Paso Pipeline Partners, L.P. Derivative Litigation*, No. 7141-VCL (Del. Ch. Apr. 20, 2015); *In re Rural/Metro Corp. S'holders Litig.*, No. 6350-VCL (Del. Ch. Oct. 10, 2014); *Chen v. Howard-Anderson*, No. 5878-VCL (Del Ch. April 8, 2014); *In re Orchard Enter., Inc. S'holder Litig.*, No. 7840-VCL (Del. Ch. Feb. 28, 2014).