# The Importance of a High-Quality Sales Process in Determining the Outcome of an Appraisal Proceeding

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Two recent decisions by the Delaware Court of Chancery underscore that the outcome of an appraisal proceeding often will turn on the quality of a company's sale process. While recent Delaware Supreme Court appraisal jurisprudence supports relying on the negotiated merger transaction price as the most reliable evidence of a seller's fair value, flaws in the sales process, even if not rising to the level of a breach of fiduciary duty by the seller's board, can lead the court to reject reliance on merger consideration. As a result, appraisal decisions likely will continue to focus on many of the same issues that courts examine when considering breach of fiduciary duty claims in the merger context as well as assessing whether the seller's stock trades in an efficient market.

## Blueblade Capital Opportunities, LLC v. Norcraft Companies, Inc.

On July 27, 2018, Vice Chancellor Joseph Slights issued a post-trial decision in *Blueblade Capital Opportunities, LLC v. Norcraft Companies, Inc.*,[1] a statutory appraisal proceeding arising out of a May 2015 transaction in which Fortune Brands Home & Security Inc. acquired Norcraft Companies, a cabinet manufacturer. After conducting a discounted cash flow ("DCF") analysis, the Court concluded that a valuation of $26.16/share, which represented 2.59% more than the $25.50/share deal price, was the most reliable measure of fair value.

Vice Chancellor Slights acknowledged the Delaware Supreme Court's embrace of deal price as a potentially strong indicator of fair value in *DFC Global Corporation v. Muirfield Oil Partners L.P.*[2] and *Dell, Inc. v. Magnetar Global Event Driven Master Fund Ltd.*,[3] but also emphasized that the Delaware Supreme Court has declined to create a rule that deal price presumptively reflects fair value. Here, Vice Chancellor Slights concluded that the deal price did not reflect Norcraft's fair value because there were "significant flaws" in the sales process, including "the absence of a pre-signing market check, failure to consider other potential merger partners, inclusion of deal-protection measures that rendered the post-signing go-shop ineffective as a price discovery tool,

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[1] C.A. No. 11184-VCS, 2018 WL 3602940 (Del. Ch. July 27, 2018).

[2] 172 A.3d 346, 388 (Del. 2017).

[3] 177 A.3d 1, 22 (Del. 2017).

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and a lead negotiator for Norcraft who 'was at least as focused on securing benefits for himself as he was on securing the best price available for Norcraft'." The Court also gave no weight to Norcroft's unaffected pre-announcement market price, concluding that because the parties did not introduce significant evidence of market efficiency, the stock was "thinly traded given the niche market in which it operated and was also thinly covered by analysts."

Consequently, Vice Chancellor Slights "borrowed the most credible components of each expert's analysis" to conduct his own DCF valuation. The Court did not rely on any precedent transactions or comparable company data, and concluded that no parties identified truly comparable companies. Instead, the Court evaluated DCF inputs and assumptions step-by-step, making determinations about which expert submitted more credible testimony for each disputed input. Finally, the Court conducted a "reality check" by comparing its own DCF valuation to the market price, and determined that it was "satisfied" that the identified deal process flaws "resulted in the Board leaving $0.66 per share on the bargaining table."

**In re Appraisal of Solera Holdings, Inc.**

On July 30, 2018, Chancellor Bouchard issued a decision in *In re Appraisal of Solera Holdings, Inc.*[4] The proceeding arose out of a March 2016 transaction in which Vista Equity Partners ("Vista") acquired Solera Holdings, Inc. ("Solera") for $55.85 per share. Solera "is a global leader in data and software for automotive, home ownership and digital identity management." Alluding to *Dell* and *DFC*, Chancellor Bouchard reiterated that the Delaware Supreme Court has twice in the past year "heavily endorsed the application of market efficiency principles in appraisal actions." Following that guidance and considering all relevant factors, the Court determined the fair value of petitioners' shares to be "the deal price less estimated synergies—i.e., $53.95 per share," or $1.90 per share less than the merger consideration.

The Court found that Solera was sold in an open process that "was characterized by many objective indicia of reliability." The process included two months of outreach to private equity firms, a six-week auction conducted by an independent and fully empowered special committee of the board, and public disclosure that the company was for sale. Moreover, the Court found no reason to question the reliability of the trading price of the company's stock immediately prior to the merger announcement, stating that "the sales process was conducted against the backdrop of an efficient and well-functioning market for Solera's stock." That the merger consideration represented a significant premium to Solera's unaffected market price was strong further evidence that stockholders received fair value in the transaction.

[4] No. CV 12080-CB, 2018 WL 3625644, at *1 (Del. Ch. July 30, 2018).
(Del. Ch. July 27, 2018) (memo op.).

**Takeaways and Analysis**

- *Solera* reiterates the uncertainty in appraisal outcomes, and the risk that the court may award less consideration than the deal price. The Court in *Solera*, similar to recent rulings we have previously discussed in *Verition Partners Master Fund Ltd. v. Aruba Networks, Inc.*,[5] *Merlin Partners, L.P. v. SWS Group, Inc.*, *In re Appraisal of AOL, Inc*., held that the fair value of the target's shares is below the deal price. This increasingly common result will likely continue to have a chilling effect on stockholders' interest in seeking appraisal in connection with merger transactions that do not result from a significantly flawed sale process. However, the *Blueblade* opinion should serve as a reminder that the appraisal remedy is still available to stockholders if significant flaws are present in the sale process or if the target's stock does not trade in an efficient market.

- A pre-signing market check remains important in a court's assessment of the quality of a company's sales process. While a pre-signing market check is not required in order for a court to conclude that a board ran an effective sales process, directors will need to demonstrate that they were informed about the possibility of other potential buyers or alternative strategic options and had a strategic reason for negotiating exclusively with the buyer. In *Blueblade*, the Court criticized Norcraft's focus on a single potential acquirer, adding that while "perhaps" not rising to the level of a breach of fiduciary duty, it "did not provide a meaningful market check as would yield a reliable indication of fair value." The Norcraft board did not "task Citi, [its financial advisor], with pursuing alternative buyers or canvassing the market," either "in hopes of securing a better offer or, at least, a source of leverage in its discussions with Fortune."

  The Norcraft board's exclusive focus on a single buyer contrasted with the approach by the board in *Solera*, where an empowered, independent committee ran a pre-signing auction. In *Solera*, the committee's financial advisor contacted 11 private equity and six potential strategic bidders, including those thought by the committee to be most likely to bid. After actively negotiating with multiple bidders, including by just saying "no" to several offers, the Solera committee incentivized bidders to raise their offers and it ultimately accepted an offer from Vista at $55.85 per share, representing a premium of 53% over Solera's closing price pre-disclosure of a potential transaction. Moreover, "the whole universe of potential bidders was put on notice, with increasing specificity over time, that the company was considering strategic alternatives" via the CEO's public statements and press reports.

- A post-signing go-shop will not "cleanse" a flawed sales process where the go-shop is structured poorly and/or run ineffectively. While a "go-shop only process" does not necessarily render deal price an unreliable measure of fair value, its utility will be subject to scrutiny in an

[5] No. CV 11448-VCL, 2018 WL 922139, at *1 (Del. Ch. Feb. 15, 2018).

appraisal proceeding, especially where there is no pre-signing market check and a "shambolic pre-signing process." In *Blueblade*, however, there were multiple problems with the structure and execution of the 35-day go-shop. The lead banker for the seller's financial advisor "had never run a sell-side go shop. Because Norcraft's board was unsure of the go shop's core components, it relied completely on [the financial advisor] to oversee the process." Prior to the go-shop, it "was not widely known that Norcraft was 'up for sale,'" putting potential bidders who would not learn that fact until the transaction was announced "several steps behind Fortune." Moreover, Fortune secured in the merger agreement an "unlimited match right" with respect to any competing proposal and the right to launch its tender offer for Norcraft "during the Go-Shop Period, understanding that both measures would make it less likely that a topping bidder would emerge." Ultimately, none of the 54 parties contacted made a bid, either because they did not want to compete with Fortune or because they could not move sufficiently quickly in 35 days.

The go-shop process in *Norcraft* contrasts sharply with the go-shop in *Solera*. The 28-day go-shop in *Solera* "afforded favorable terms to allow a key strategic competitor of Solera to continue to bid for the company." Solera negotiated an arrangement with Vista to reduce the deal termination fee and enable a go-shop period, facilitating Solera's discussions with its strategic competitor and potential bidder, IHS, Inc. Solera granted IHS access to the 12,000-document data room, but IHS ultimately declined to pursue an acquisition.

- Buy-side financial advisors should not seek to obstruct a seller's sale process or go-shop process. In *Norcraft*, the buyer's financial advisor in connection with the acquisition sought to dissuade other potential Norcraft buyers from making acquisition proposals during the go-shop process by contacting them directly and discouraging them from bidding. Such interference in the go-shop process may render the entire process inadequate to justify reliance on the deal price as a basis for fair value. In addition to potentially prejudicing its client in connection with an appraisal claim, buyer-side go-shop interference could also expose financial advisors to liability for claims from the seller for intentionally interfering with prospective economic advantage and from the buyer for breaching its contractual obligations. All that is in addition to the reputational harm that accrues from such conduct.
- Both *Solera* and *Blueblade* endorsed a deal price less synergies measure of fair value in a "'*Dell*-compliant' transaction" involving a target that trades in an efficient market. Citing recent Delaware Supreme Court precedent providing that the deal price should be given "heavy, if not dispositive weight,"[6] Vice Chancellor Slights and Chancellor Bouchard in *Blueblade* and *Solera*, respectively, appeared to adopt the notion that an efficiently traded target company stock combined with a "*Dell*-compliant" sales process would result in a determination of fair value equal to the deal price, less synergies. A target company's stock will generally be considered to trade in an efficient and well-functioning market if it is traded by a large number of investors who

[6] *DFC Global Corp. v. Muirfield Value Partners, L.P.*, 172 A.3d 346 (Del. 2017).

are able to quickly digest publicly available information and calibrate their trading activity based on the consensus valuation of the company, and a sales process will generally be deemed "*Dell*-compliant" if it is open and independent, and free from unnecessary complications and impediments to participation. Furthermore, the *Solera* opinion clarified a common misconception that synergies are only available in transactions involving a strategic buyer. To the contrary, the Court stated that synergies may also be present in situations involving a financial buyer, if such a buyer can realize efficiencies resulting from ownership of its other portfolio companies.

In important ways, *Solera* also diverged from *Aruba*, which found that the most reliable evidence of the fair value of an efficiently traded seller is the company's unaffected market price, not merger consideration less synergies. In its opinion, the *Solera* Court questioned whether lower post-merger "agency costs" – i.e., cost reductions attributable to the merger stemming from the benefits of control, such as greater operating efficiencies, increased market share, economies of scale, and the like – should as in *Aruba* be deducted from the calculation of fair value. Chancellor Bouchard questioned whether in every instance agency costs in fact represent an element of the value created from the merger. As an example, the Court noted that the value of control may properly be thought of as part of a business' going concern value, rather than an element of value created by a merger and subject to deduction from fair value. *Aruba* has been appealed to the Delaware Supreme Court, and we can therefore expect additional guidance on this point in the near future.

- Conflicts, or the absence thereof, on the part of directors or advisors are significant indicia of a flawed or, alternatively, well-run sales effort. The lead negotiator's conduct matters, especially any attempts to secure post-transaction benefits for himself in the form of employment or business opportunities. The seller's lead negotiator in *Blueblade*, the CEO Mark Buller, sought to extract personal benefits for himself at the same time he was negotiating a potential transaction: after unsuccessfully attempting to obtain commitments from the buyer for employment in the post-transaction company, Buller sought and obtained a commitment for other personal benefits, including waiver of a non-compete and a potential severance payment after the acquisition. As described by the Court, "Norcraft's board left the negotiations principally to Buller. Yet Buller was just as (if not more) fixated on extracting commitments from Fortune" that would benefit him alone while Fortune was "stringing Buller along as it negotiated with him over the Merger Price."

  The Solera sales process also was not perfect on this front, although not as egregious as in *Norcraft*. While the CEO Tony Aquila engaged in one-on-one conversations with private equity firms before the special committee was formed, the Court acknowledged the "reality . . . that Aquila's participation in a transaction was a prerequisite for a financial sponsor to do a deal. As petitioners put it, 'Aquila is Solera.'" And, in fact, all the private equity firms submitting bids "made clear that those bids depended on Aquila continuing to lead the Company." Although that aspect of the process did not trouble the Court, it did observe that the special committee

"should have monitored Aquila's contacts with potential bidders more carefully," specifically citing Aquila's private meeting with Vista "shortly after which Vista began to model a larger option pool for post-merger Solera executives. . . . If best practices had been followed, a representative of the Special Committee would have accompanied Aquila to the August meeting with Vista as a precaution." Nonetheless, the Court found that "nothing in the record indicates that" any of Aquila's actions "compromised or undermined the Special Committee's ability to negotiate a deal."

- The seller's board is responsible for managing the sales process and any conflicts on the part of its advisors or management who are involved in the potential transaction. In *Blueblade*, the Norcraft board "did nothing to manage [Buller's] conflict – it did not form a special committee of its members to negotiate with Fortune or take any other steps to neutralize Buller's influence." By contrast, once the Solera board determined to "test the waters" regarding a sale, it "recognized that Acquila," the company's CEO, chairman and president, "would probably have a significant equity stake in a private Solera, posing an inherent conflict in his outreach to private equity firms." As a result, the board formed a special committee of independent directors, which was "granted the full power and authority of the board," to review, recommend or reject proposed transactions or other strategic alternatives. The committee consisted of three outside directors, "each of whom had served on multiple boards and had extensive M&A experience," and it retained its own outside legal and financial advisors.
- Information asymmetries among the preferred merger partner and other potential bidders can undermine the effectiveness of a sales process by creating a "winner's curse" scenario characterized by potential bidders being dissuaded from pursuing the seller for fear of buyer's remorse. Fortune, the preferred merger partner in *Blueblade*, was granted exclusivity and therefore a "substantial head start relative to other potential suitors." In *Solera*, on the other hand, the Special Committee distributed a document to management referred to as the "Rules of the Road," which stated that "'senior management must treat all potential bidders equally' and refrain from 'any discussions with any bidder representatives relating to any future compensation, retention or investment arrangements, without approval by the independent directors.'" By adhering to these "Rules of the Road" throughout the sales process, the Solera committee created a situation that maximized the opportunity for multiple competing bids for the company.
- To persuade a court that the unaffected trading price immediately before announcement of a potential transaction is probative of fair value, parties must introduce evidence that the market for the company's stock is efficient. In *Blueblade*, the Court declined to assign any weight to evidence of the company's unaffected market price because, among other things, it had a "limited public trading history given that it had just completed an IPO eighteen months before the merger," and post-IPO had traded thinly with little analyst coverage. As a result, the Court was unable to conclude that the market for Norcraft's common stock was efficient. In *Solera*, the

evidence supported the conclusion that the market for Solera's stock was efficient and well-functioning, including that it was actively traded, covered by at least 11 equity analysts, its price "moved sharply" in response to sales rumors, and investors who sold short would be able to cover positions relatively quicker than comparably sized companies. As a result, the Court concluded that Solera's unaffected market price was evidence of its fair value at that time and as such was probative of the fact that the premium paid by Vista to the market price also was above the company's fair value.

The *Solera* Court also assessed the impact of volatility on assessments of market efficiency, rejecting the argument that "macroeconomic volatility, evidenced by the VIX [a measure of market volatility tied to S&P 500 options] spiking to a historic high and sharp declines in global equity markets," constrained bidders' "ability to finance and willingness to enter into a deal." According to the Court, it was "questionable" whether there even was "extraordinary" market volatility in the relevant period and, even if there was such volatility, appraisal petitioners are "only entitled to the fair value of Solera's stock at the time of the Merger, not to the best price theoretically attainable had market conditions been the most seller-friendly." In *Blueblade*, on the other hand, the Court acknowledged that Norcraft's stock traded in a cyclical industry, where demand for cabinetry, like the larger home improvement industry it operates in, is "affected by macro-economic conditions," including employment levels, interest rates, and housing construction. Nonetheless, the Court did not apply these facts to a market efficiency analysis, because the Court still had insufficient evidence to consider the efficient market hypothesis.

- <u>Courts will assess the effectiveness of the seller's board and advisors in negotiating for a higher price and fewer deal protection mechanisms in the merger agreement when evaluating whether deal price is a reliable indicator of fair value</u>. On the one hand, the open and public bidding process in *Solera* bolstered the reliability of the negotiated deal price as evidence of fair value. On the other hand, in *Blueblade*, while the board was successful in getting Fortune to raise its offer price from $22.00 per share initially to its "best and final offer" of $25.50 per share, two directors involved in negotiations along with Buller "remained focused exclusively on Fortune" notwithstanding their belief that the final proposal "significantly undervalued Norcraft." In negotiating with Fortune, the board responded to Fortune's final $25.50/share offer with a counter-proposal of $27.50 per share, which was rejected, and then "bid against itself with a second counterproposal" of $26.50/share. Ultimately the board "capitulated" at $25.50/share. The ineffectiveness of Norcraft's board in negotiating a transaction stands in contrast to Solera's committee, which "demonstrate[d] a real willingness to reject inadequate bids." According to the Court, the committee "actively engaged with the bidders, did not favor any one in particular, and expressed a willingness to walk away from bids that it did not find satisfactory." The Court stated the committee "critically" extracted reduced deal protection mechanisms in the form of a lower termination fee with respect to one strategic bidder that expressed interest in the go-shop and also negotiated for the right to conduct a go-shop in the first place.

- Valuation experts must maintain their credibility with the Court in order to remain effective, even at the cost of a relatively less favorable valuation figure. In *Blueblade*, Vice Chancellor Slights suggested that expert witnesses in Chancery Court are increasingly perceived as partisans: "It is accepted in Delaware appraisal litigation that paid valuation experts have assumed more of an advocacy role, and less of a traditional expert witness role (as illustrated by the wide deltas we regularly see in their valuation conclusions)." Nonetheless, experts should not strain credibility by offering an overly skewed valuation. Otherwise, courts may share Chancellor Bouchard's reaction to the petitioner's expert in *Solera* claiming the company's shares were undervalued by 51.6%. Chancellor Bouchard, observing the wide divergence between deal price and petitioner's expert valuation, declared it "facially unbelievable" that potential buyers left almost $2 billion on the table. Solera, on the other hand, initially argued that the best evidence of fair value was the deal price less synergies, which equaled $53.95 per share. But after the Delaware Chancery Court issued its opinion in *Aruba*, Solera revised its position to argue that the best indicator of fair value was the unaffected market price of $36.39 per share. "This argument, which advocates for a fair value determination about 35% below the deal price, reflects a dramatic change of position that I find as facially incredible as petitioners' DCF model." Likewise, in *Blueblade*, the Court also rejected the DCF valuations put forth by the parties' experts, who argued that the fair value of Norcraft was either $34.78 (petitioners) or $21.90 (Norcraft). The Court criticized both experts for making "choices in their analyses that were not supported by the evidence or not supported by 'accepted financial principles' in order to support a desired outcome."

- Management projections created specifically in connection with a potential transaction, even if not prepared in a manner consistent with preparation of annual projections, nonetheless may be deemed reliable. The experts in *Blueblade* did not dispute the reliability of management's base case projections. Instead, both experts relied on the projections for their DCF analyses. The Court also adopted the base case projections as the starting point for its DCF analysis, even though the transaction projections were not prepared in ordinary course fashion. In particular, each year management prepared one-year projections in a budgeting process characterized by a "bottoms-up" approach whereby each division creates initial projections that ultimately are revised and approved by senior management. In contrast, the projections created in connection with the transaction were "top-down," created in the first instance by senior management and then subjected to input from division-level executives, for a five-year period, not the typical one-year horizon. Nonetheless, the Court found the base-case, five-year, top-down projections reliable because management "knew how to prepare long-term projections and they approached the Base Case projections with a view to providing the Board with a reliable estimate of Norcraft's future financial performance" and "[w]hile not perfect, I am satisfied the Base Case projections provide a reliable foundation for a valid DCF."

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