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How Delaware Courts Are Approaching Appraisal Valuation

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(September 4, 2018, 12:50 PM EDT)

Predicting the price likely to result from a judicial appraisal of an acquired company's shares continues to vex acquirers and stockholders alike. The principles for determining appraisal values received a lot of attention following the Dell and DFC decisions by the Delaware Supreme Court in the latter part of last year, each of which reversed a Delaware Chancery Court decision that had found a company's appraisal value to be greater than the underlying deal price.[1] In both cases, the Delaware Supreme Court endorsed reliance on efficient market principles, but declined to establish a presumption in favor of the negotiated deal price, even in an arm's-length transaction, and reiterated the obligation of a court conducting an appraisal valuation to consider "all relevant factors."

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Two recent Delaware Chancery Court decisions illustrate the ways that courts are approaching appraisal valuation in light of this guidance, and the ways that valuation methodologies can diverge, depending on the underlying deal process and other factors:

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- In Solera Holdings, the court found the company's sales process was "open," with "the requisite objective indicia of reliability," and, after considering other factors, looked exclusively to the deal value, determining the appraisal value to be the deal price minus the synergies expected to be gained by the buyer (about 3.5 percent below the deal price).[2]
- In Norcraft Companies, the court found the sales process did not include a "meaningful" market check, and conducted its own financial analysis, determining the appraisal value to be approximately 2.5 percent above the deal price.[3]

The cases emphasize the importance of deal process, market efficiencies and documenting synergies.

Solera Holdings

In March 2016, Vista Equity Partners, a private equity firm, acquired Solera for approximately $3.85 billion in equity value.

In the appraisal action, Chancellor Andre Bouchard found that the sale process showed "many objective indicia of reliability," including a two-month outreach to large PE firms, a subsequent six-week auction by a special committee, which contacted 11 financial and seven strategic firms, and public disclosures during the sale process that made it clear that the company was for sale. The court also noted that the deal's 28-day go-shop, which facilitated continued bidding by a key strategic competitor that had been brought into the process relatively late, and longer window-shop "proved" that the merger price was a market clearing price. The court also found that there was "an efficient and well-functioning market" for Solera's stock, with a deep base of public stockholders, active trading on the New York Stock Exchange, and coverage by numerous analysts, as well as debt that was "closely monitored by the ratings agencies." The court inferred that the trading price for such a stock "may provide an informative lower bound" for the parties negotiating the sale price.

The court accordingly gave the deal price "sole and dispositive weight" in valuing the company. In doing so, the court noted that "[o]ver the past year, our Supreme Court twice [i.e., in Dell and DFC] has heavily endorsed the application of market efficiency principles in appraisal actions." In adjusting the deal price for synergies, the court stated that synergies are not limited to strategic buyer contexts, and noted the "touch points" that several of Vista's portfolio companies had with Solera. The court noted that Vista had modeled out synergies during the bidding process, and looked to an expert valuation of synergies arising with respect to portfolio company revenue, private company cost savings and tax benefits of incremental leverage, and to empirical studies showing the portion of synergies that "remained with" sellers. The court accordingly subtracted $1.90 from the merger price of $55.85 based on Vista's expert's trial testimony about the value of synergies, to get an appraisal value of Solera of $53.95

In keeping with its obligation to consider "all relevant factors," the court also considered the "dueling" discounted cash flow valuations that had been presented by the company and the stockholders. However, the court found that the stockholders' DCF analysis was not credible on its face, given the "huge gap" between the resulting valuation and the deal price, and that the company considered the company's own DCF analysis, which resulted in a value closer to the deal price, less reliable than the deal price minus synergies.

The court declined to value Solera based on the pre-announcement unaffected trading price, as had been done in the Aruba appraisal,[4] which was decided during the pendency of the Solera proceedings and which would have reduced fair value to 35 percent below the deal price. The court noted that the company had not argued that adjusting the fair value for agency costs was appropriate until later in the proceedings, after the company already had argued that the "best evidence" of Solera's fair value was the deal price adjusted for synergies. The court also declined to find that the Delaware Supreme Court in Dell or DFC had suggested that agency costs, like synergies, must be deducted from deal value.

Norcraft Companies

In May 2015, Fortune Brands Home & Security Inc. acquired Norcraft at a reported enterprise value of approximately $600 million.

In the appraisal action, Vice Chancellor Joseph Slights acknowledged "the Delaware Supreme Court's embrace of deal price as a strong indicator of fair value." However, the court found that there were "significant flaws" in the sales process, including that there was no pre-signing market check, Norcraft

and its advisers "fixated" on Fortune, and Norcraft's lead negotiator was "at least as focused on securing benefits for himself as he was on securing the best price available" for the company. The court noted that a single-bidder process, by itself, does not preclude finding that a resulting deal price provides a reliable indication of fair value, but found that here there was no evidence that the single-bidder process was the result of a "strategic choice" and, "more troubling," that the focus on one bidder was tainted by conflicts of interest involving Norcraft's lead negotiator.

The deal included a 35-day go-shop, during which the company's banker contacted 12 potential strategic bidders and 42 PE firms. However, the court found that the go-shop was "ineffective" as an indicator of value because, among other things:

- The nominal 35-day go-shop period effectively was shorter, since a competing bidder would have to allow time for Fortune's matching rights, and the tender offer was likely to close promptly after the end of the go-shop period given, among other things, support agreements requiring the tender of approximately 54 percent of Norcraft's outstanding shares;
- Prior to commencement of the go-shop, it was not known that Norcraft was for sale, so other potential bidders had to start "several steps" behind Fortune;
- Norcraft's board did not seem to understand the terms and function of the go-shop; and
- Fortune had an unlimited match right.

The court also found no justification for looking to unaffected market prices, including because Norcraft was "fresh off" its November 2013 initial public offering, was relatively thinly traded, and was thinly covered by analysts.

The court thus conducted its own DCF analysis, and found that the fair value of Norcraft at the time of the merger was approximately 3 percent above the deal price. The court also looked to the deal price, but only as a "reality check" on its DCF conclusion, and found that the 3 percent differential was "not so great as to cause me to question whether the DCF value is grounded in reality."[5]

Takeaways

The Delaware Supreme Court has eschewed bright-line tests for determining the value of a company in an appraisal. However, the analyses in Solera and Norcraft reflect several points.

Significance of Deal Process

Following Dell and DFC, a court finding that a deal process provides reliable indications of value is likely to give great (even dispositive) weight to the deal price. Both the Solera court and the Norcraft court acknowledged the weight given to deal price in the Delaware Supreme Court's recent appraisal decisions and began their analyses with a review of the sales process to determine whether the sales process justified such reliance on the deal price. Of course, the significance of such a review raises questions for a buyer, since it is hard for a buyer to know in advance exactly what kind of deal process a target company has run (though a buyer may have some indications during the process, such as the approaches made to Fortune by the conflicted executive in Norcraft).

Potential Limits of a Go-Shop in Supporting Deal Price

Both Solera and Norcraft involved go-shops. In Solera, the go-shop was viewed favorably as helping to "prove" the market-clearing effect of Vista's bid, but was part of a process that included a pre-signing market check as well as pre-signing public disclosures that the company was considering alternatives and a longer window-shop after signing, during which unsolicited bids could be accepted. In Norcraft, the court acknowledged that a pre-signing market check is not required, but gave little weight to the go-shop in that instance, given the timing constraints, particularly as compared to the time available to Fortune, and other restrictions on potential bidders, such as Fortune's information and matching rights.

Documenting Synergies to Reduce Fair Value

A court looking to a deal price as an indicator of fair value should reduce the deal price by the amount of synergies reflected in the deal price. The court's determination of the value of synergies from a transaction is likely to be affected by the synergies contemplated or discussed by the parties during the deal process as well as by the buyer's calculations and the court's determination of how the synergies were shared. In particular, the Solera court noted that the buyer considered synergies in its financial analysis of Solera during the bidding process.

Continued Potential for Appraising at Pre-Announcement Trading Price

Both the Solera and the Norcraft courts considered whether a company's unaffected trading price was probative of fair value and noted the finding in Aruba of an appraisal value equal to the unaffected trading price. The Norcraft court found that the evidence regarding the market for the company's shares did not justify reference to the unaffected trading price, while the Solera court appeared to reject the use of the unaffected trading price more generally. Given the different uses by different courts and the potential for large differences in value, both buyers and stockholders are likely to look carefully at this potential factor, at least pending further guidance from the Delaware Supreme Court.

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[1] For a discussion of the Dell decision, see our client alert dated Dec. 26, 2017.

[2] In re Appraisal of Solera Holdings Inc., Del. Ch. July 30, 2018.

[3] BlueBlade Capital Opportunities LLC v. Norcraft Companies Inc., Del. Ch. July 27, 2018.

[4] Verition Partners Master Fund Ltd. v. Aruba Networks Inc. (Del. Ch. Feb. 15, 2018); see our prior discussion.

[5] While the buyer's expert in Norcraft estimated that the deal price reflected synergies of $3.60 per share, because the court relied on a DCF analysis — which values a company on a stand-alone basis — the court did not discuss the value of synergies from the transaction.