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Norcraft Appraisal: Chancery Court Gives No Weight to Deal Price Negotiated in a Conflicted CEO-Led Transaction with a Flawed Sales Process

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Chancery Court valuation relies exclusively on a discounted cash flow analysis while giving no weight to negotiated deal price or trading price

INTRODUCTION

Delaware General Corporation Law § 262 ("*DGCL § 262*") allows target-company stockholders to challenge the price paid for their shares in a merger by asking the Delaware Court of Chancery ("*Chancery Court*") to determine the fair value of their shares in a statutory appraisal action. DGCL § 262 directs the Chancery Court to determine the "fair value" of shares using "all relevant factors." The statute, however, commands the Chancery Court not to take into consideration "any element of value arising from the accomplishment or expectation of the merger" (i.e., deal price less any synergistic gains). At bottom, the vague criteria in DGCL § 262 give the Chancery Court significant discretion in determining fair value.

In exercising this significant discretion, the Chancery Court traditionally has favored the negotiated deal price as the starting point for determining fair value. Nonetheless, in 2017, the Delaware Supreme Court declined in both *DFC Global Corporation v. Muirfield Value Partners, L.P.*, 172 A.3d 346 (Del. 2017) and *Dell, Inc. v. Magnetar Global Event Driven Master Fund Ltd.*, 177 A.3d 1 (Del. 2017) to establish negotiated deal price as the presumptive indicator of fair value. (For a discussion of these decisions, *see* Robert S. Reder & Blake C. Woodward, *Delaware Supreme Court Refuses to Establish a Presumption Favoring Deal Price in Statutory Appraisal Proceedings*, 71 VAND. L. REV. EN BANC 59 (2018) and Robert S. Reder & Micah N. Bradley, *Dell Appraisal: Delaware Supreme Court Rejects Chancery Court Valuation Giving No Weight to Deal Price in Connection with Management-Led LBO*, 72 VAND. L. REV. EN BANC 201 (2019).)

According to the *DFC* Court, "[i]n some cases, it may be that a single valuation metric is the most reliable evidence of fair value and that giving weight to another factor will do nothing but distort that best estimate. In other cases, it may be necessary to consider two or more factors." Although reluctant to establish a bright-line rule, the *DFC* Court did proclaim:

> Although there is no presumption in favor of the deal price . . . . economic principles suggest that the best evidence of

> fair value was the deal price, as it resulted from an open process, informed by robust public information, and easy access to deeper, non-public information, in which many parties with an incentive to make a profit had a chance to bid.

Likewise, given the rigorous sale process employed by Dell's board of directors, the *Dell* Court held that "heavy, if not dispositive, weight" should have been given to the negotiated deal price and rejected the Chancery Court's exclusive reliance on its own discounted cash flow ("*DCF*") analysis.

Against this backdrop, in *Blueblade Capital Opportunities LLC v. Norcraft Companies, Inc.*, No. CV 11184-VCS, 2018 WL 3602940 (Del. Ch. July 27, 2018) (hereinafter "*Norcraft Appraisal Action*"), the Chancery Court determined that neither the deal price produced by the sales process employed by the target company's board of directors, nor the target company's public trading price, was a reliable indicator of the fair value of the target company's shares. Instead, the Chancery Court used its own DCF analysis to determine fair value. *Norcraft Appraisal Action* helpfully analyzes the flaws in a sale process—especially during a post-signing go-shop period—that can spur the Chancery Court to discount, or even give no weight to, negotiated deal price in determining fair value for purposes of DGCL § 262.

I. FACTUAL BACKGROUND

A. The Fortune-Norcraft Transaction

Norcraft Companies, Inc. ("*Norcraft*"), "a leading manufacturer of kitchen and bathroom cabinetry in the United States and Canada," completed its initial public offering ("*IPO*") on November 13, 2013. One of its principal competitors, Fortune Brands Home & Security, Inc. ("*Fortune*"), was "a home and security products company with four business segments: cabinets, plumbing, doors and security." The cabinetry industry is "cyclical," impacted "by macro-economic conditions" and "directly affected by housing starts." Indeed, "Norcraft was no exception . . . ."

On October 20, 2014, following an upturn in Norcraft's financial performance after a lengthy period of stalled growth in the wake of the housing crisis, Fortune's financial advisor, RBC Capital Markets, LLC ("*RBC*"), contacted Norcraft CEO Mark Buller to advise him of Fortune's interest in "a potential acquisition of Norcraft." In a follow-up meeting, Buller informed Fortune CEO Christopher Klein that although Norcraft "was not for sale," he would advise Norcraft's board of directors ("*Board*") of Fortune's interest. Buller also advised Klein, as he continued to do throughout the negotiations, of his desire to land a role in any post-merger company. Although "Fortune was disinclined to bring Buller on board," Klein remained "noncommittal" until much later in the process.

At the close of their meeting, Klein handed Buller "a written, non-binding proposal" for Fortune to acquire Norcraft for $22.00 cash per share, as well as to satisfy Norcraft's obligations under certain tax receivable agreements ("*TRAs*") previously entered into with pre-IPO stockholders (including, notably, Buller). The TRAs required Norcraft to make payments to these stockholders out of tax savings realized after the IPO. These payment obligations accelerated upon a Norcraft change of control. Fortune's proposal suggested an efficient two-step transaction structure typical of all-cash acquisitions: a tender offer followed by a merger. After receiving a report from Buller, the Board engaged legal counsel and its financial advisor, Citigroup Global Markets Inc. ("*Citi*"), to evaluate Fortune's proposal.

In the ensuing months of negotiations, Norcraft rejected Fortune's initial offer as well as a revised offer of $25.00 per share. However, the Board "did not reach out to other potentially interested parties in hopes of securing a better offer or, at least, a source of leverage in its discussions with Fortune." In fact, "the Board remained focused exclusively on Fortune." When Fortune made its "best and final offer" of $25.50 per share and rejected counter-proposals from Norcraft, the Board was "less than thrilled" but nevertheless "capitulated" on February 21, 2015, "hoping to extract further value during a post-sign go-shop." To facilitate negotiation of the other transaction terms, the Board granted Fortune a thirty-day exclusive negotiating period.

On February 27th, the parties settled on a thirty-five day post-signing go-shop (the midpoint between Norcraft's initial ask of twenty-five days and Fortune's counteroffer of forty-five days). The go-shop placed no restrictions on the potential bidders Norcraft could contact. The parties also negotiated a two-tiered termination fee: a $10 million fee if Norcraft accepted a competing proposal the Board determined to be superior during the go-shop period "and a $20 million termination fee otherwise." Fortune "secured information rights with respect to competing proposals" together with "unlimited" rights to match superior proposals. With "a final stroke of masterful bargaining," Fortune procured the right to launch its first-step tender offer fifteen days after commencement of the go-shop and to accept tendered shares, if the Board had not terminated the transaction to accept a superior proposal, by the expiration of the go-shop.

On March 6th, Klein finally informed Buller that Fortune would "have no place for him" after the merger. As a result, Buller became "increasingly disruptive" as negotiations of the final merger terms continued, which "risked derailing the deal." Specifically, Buller made two more attempts to further his interests:

- *First*, Buller sought assurances Fortune would sell him Norcraft's Canadian operations post-merger. At this point, the Board determined Buller was conflicted and excluded him from the remainder of the negotiations with Fortune. In an effort to "keep the peace," Fortune assuaged Buller by agreeing to provide "some meaningful comfort" on Canadian operations including waiver of a "Canada-specific non-compete covenant otherwise applicable to Buller" and a severance payment if Buller's employment was terminated "without cause" in the twelve months following the merger.

- *Second*, Buller rejected Fortune's offer to resolve a $3 million difference in the parties' calculation of the payments due under the TRAs by paying $2 million. To appease Buller, the two largest TRA beneficiaries agreed to waive $1 million of the TRA payments owed to them, thereby freeing this amount for increased payments to Buller and the other TRA beneficiaries.

With these issues settled, Fortune sought to lock up the support of the TRA beneficiaries, who controlled a majority of Norcraft's outstanding shares. To that end, Fortune negotiated Tender and Support Agreements ("*TSAs*") with TRA beneficiaries owning 53.6 percent of the outstanding shares. The TSAs provided that:

- the signatories would tender their shares into Fortune's first-step tender offer "at least two days before the offer's initial expiration date"; and

- the tendered shares could not be withdrawn unless the tender offer expired or "terminated in accordance with the terms of [the] Merger Agreement."

After receiving Citi's fairness opinion, on March 29th, the Board approved a merger agreement with Fortune (the "*Merger Agreement*"). The parties signed the Merger Agreement the next day and, concurrently, the TSAs were entered into. Under the go-shop, which commenced that day, "Citi contacted fifty-four potential bidders: twelve potential 'strategic' bidders and forty-two private equity firms." None of these potential bidders, who generally either were not interested in competing with Fortune or thought the deal price too high, submitted an offer. Two informed Citi "they could not 'move fast enough [to submit a bid] in 35 days.' "

Then, fifteen days into the go-shop period, as permitted by the Merger Agreement, Fortune launched its tender offer for Norcraft's outstanding common stock. The go-shop period ended as scheduled on May 4th with Norcraft receiving no competing proposals. The tender offer was completed on May 11th, and the merger became effective the next day.

B. Appraisal Proceeding

Holders of 557,631 Norcraft shares ("*Dissenting Stockholders*") dissented from the merger and demanded an appraisal of their shares under DGCL § 262. The Dissenting Stockholders claimed flaws in the sale process rendered the negotiated deal price an unreliable indicator of fair value. Accordingly, their valuation expert offered a DCF analysis estimating fair value at $34.78 per share. By contrast, Norcraft's valuation expert argued for a fair value based on the deal price less synergistic gains estimated at $3.60 per share, yielding a fair value of $21.90 per share. Norcraft's valuation expert also submitted, but did not rely on, analyses of comparable companies and precedent transactions yielding values between $17.48 and $23.46.

The Dissenting Stockholders also retained a "deal process expert," Harvard Law and Business School Professor Guhan Subramanian ("*Professor Subramanian*"), to critique the Board's sale process. Because the Chancery Court credited several of Professor Subramanian's critiques, it is worth noting the bases for his conclusion the sales process "was flawed in several respects," rendering it "unlikely to have yielded fair value for the Norcraft shareholders":

- *Absence of Pre-Signing Competition.* The Board's single-bidder strategy focusing only on Fortune "eliminated a standard source of bargaining leverage" that might have been helpful in negotiating an increase in Fortune's "best and final offer." Further, "it does not appear 'that Norcraft extracted something else' " from its grant of thirty-day negotiating exclusivity to Fortune. These shortcomings in the pre-signing process "meant that the Norcraft Board was relying on [the] go-shop process to ensure that Norcraft shareholders received fair value." But Professor Subramanian found this reliance "misplaced because Norcraft's go-shop process was so poorly structured that it was rendered entirely ineffective as a price discovery tool."

- *Informational Asymmetries.* Whereas Fortune had several *months* to perform due diligence on Norcraft to support its bid, any participants in the go-shop would have had to complete their due diligence and bid package in a matter of *weeks*. Moreover, according to Professor Subramanian, given Fortune's "informational advantage," any bidder considering a topping bid would be wary of risking the "winner's curse" of paying more for a company than a more informed bidder was willing to pay.

- *Deal Protection Mechanisms.* Professor Subramanian also testified that the confluence of several factors effectively "truncated" the go-shop period from thirty-five to thirty days. These were: (1) Fortune's ability to (a) commence its tender offer fifteen days into the go-shop period and (b) accept tendered shares unless a "full-blown superior proposal" was available for acceptance by Norcraft, (2) the TSAs' requirement that a majority of outstanding voting stock be tendered not later than two days before the offer's initial expiration date, and (3) Fortune's unlimited matching rights. In fact, he posited that Fortune's "unlimited match right stands alone as a disabling feature." Overall, he characterized Fortune's ability to negotiate these mechanisms, combined with the Board's apparent lack of appreciation for how they "might work to hinder the go-shop," as "the Fortune side . . . playing chess and the Norcraft side . . . playing checkers."

II. VICE CHANCELLOR SLIGHTS'S ANALYSIS

In determining the fair value of Norcraft stock for purposes of DGCL § 262, Vice Chancellor Joseph R. Slights III, while taking notice of the Delaware Supreme Court's opinions in *DFC* and *Dell*, ultimately gave no weight to the negotiated deal price or the trading price of Norcraft stock. Instead, the Vice Chancellor relied exclusively on his own DCF analysis to arrive at a fair value.

A. No Weight Given to Negotiated Deal Price

The Vice Chancellor pointed to "significant flaws in the process leading to the Merger that undermine the reliability of the Merger Price as an indicator of Norcraft's fair value." Specifically, "Norcraft's deal process did not include a meaningful market check and, consequently, the Merger Price was not 'arrived upon by the collective views of many sophisticated parties with a real stake in the matter.' "

1. A "Shambolic" Pre-Signing Process

First, the Court faulted the pre-signing deal process. Prior to executing the Merger Agreement, Norcraft negotiated "with Fortune and Fortune alone." "[W]hile perhaps not amounting to a breach of fiduciary duty" in the *Revlon* context, the Vice Chancellor (echoing Professor Subramanian's critique) found no evidence that Norcraft used its single-bidder approach to "achiev[e] a strategic advantage or maximiz[e] value." Although "negotiating with a single potential buyer pre-signing can, in certain instances, lead to significant value," the Vice Chancellor found that, under the circumstances, Norcraft failed to provide itself with an opportunity to invoke the threat of an alternative deal to negotiate with Fortune for better terms. He also found that the Board failed to extract anything from Fortune in exchange for granting thirty-day exclusivity.

Further, "and more troubling" from the Vice Chancellor's point of view, the Board allowed its "conflicted" CEO to act as Norcraft's primary negotiator "from start to finish." The Vice Chancellor observed Buller was "just as (if not more) fixated on extracting commitments from Fortune regarding the TRAs and his future role with the combined company as he was on securing the best price possible for Norcraft." To compound the problem, the Board did nothing to manage Buller's conflict aside from a "half-hearted" effort to recuse him from the deliberations, only after Buller announced late in the process that he would pursue the acquisition of Norcraft's Canadian operations post-merger.

2. A Flawed Post-Signing Go-Shop

The "shambolic" nature of the "single-bidder pre-signing process led by a conflicted negotiator" made it "imperative" for the post-signing go-shop to serve as "a meaningful market check." In effect, the Board "put all eggs in the go-shop basket as a means to achieve fair value for

Norcraft stockholders.” However, the Vice Chancellor identified several significant flaws in the go-shop, many reminiscent of Professor Subramanian’s pointed critique:

- Because “it was not widely known that Norcraft was ‘up for sale’ ” prior to the go-shop, potential bidders in the go-shop found themselves “several steps behind Fortune in pursuing an acquisition of Norcraft,” but with only a limited period of time to catch up.

- The Board “appeared to lack even a basic understanding of the terms and function of the go-shop,” forcing it to rely on its financial advisor Citi to navigate the process.

- Potential bidders were required to analyze the tax implications of the complex TRAs during the abbreviated go-shop period, whereas Fortune and its tax advisors had many months to do so.

- The Merger Agreement’s requirement that Norcraft receive a superior proposal by the end of the go-shop period, rather than allowing the Board to continue negotiating a competing proposal that it determined could later reasonably become a superior proposal, effectively required potential bidders to “get the whole shebang done” by the end of the thirty-five day go-shop period.

- Finally, the Vice Chancellor characterized the effective truncation of the go-shop period from thirty-five to thirty days as a “final stroke of masterful bargaining” putting added pressure on potential go-shop bidders to accelerate their approach.

B. No Weight Given to Trading Price

In a much briefer analysis, Vice Chancellor Slights concluded he could not rely on Norcraft’s unaffected trading price as an indicator of fair value. At the time of the merger, “Norcraft was fresh off an initial public offering of its stock, was relatively thinly traded given the niche market in which it operated and was also thinly covered by analysts.” “Under these circumstances,” the Vice Chancellor declared, “I can discern no evidence-based rationale that would justify looking to the unaffected trading price of Norcraft’s stock either as a standalone indicator of fair value or as a data point underwriting the use of a deal-price-less-synergies metric."

C. The Vice Chancellor's DCF Analysis

Having rejected all other valuation metrics, Vice Chancellor Slights "turned to a 'traditional valuation methodology,' a discounted cash flow . . . analysis, to calculate the fair value of Norcraft . . . ." Such a DCF analysis "can provide the court with a helpful data point about the price a sale process would have produced had there been a robust sale process involving willing buyers with thorough information and the time to make a bid." But because he was not satisfied with the analysis offered by either parties' expert, which were "miles apart," the Vice Chancellor performed his own DCF analysis, borrowing "the most credible components" from each expert.

The DCF methodology employed by the Vice Chancellor produced a fair value of $26.16 per share, higher than the $25.50 per share negotiated deal price and in between the competing experts' estimated fair values of $21.90 and $34.78 per share. In a "reality check" comparison, the Vice Chancellor justified the "$0.66 per share delta" between the negotiated deal price and his DCF calculation as money the Board effectively left "on the bargaining table" due to "the identified flaws in Norcraft's deal process."

CONCLUSION

Notwithstanding the weight accorded to the negotiated deal price in *DFC* and *Dell*, Vice Chancellor Slights refused to accept the negotiated deal price in *Norcraft Appraisal Action*. In fact, the Vice Chancellor did not give any weight to the negotiated deal price, trading price, or any analyses of comparable companies or precedent transaction. This should serve as a warning to target companies and their legal advisers that, although a single-bidder strategy coupled with a post-signing go-shop may pass muster under a *Revlon* analysis, such an approach may not carry the day in a DGCL § 262 appraisal action. Flaws in the sale process do not have to rise to the level of a breach of fiduciary duty to undermine the negotiated deal price as an indicator of fair value. Notably, according to the Vice Chancellor and Professor Subramanian, the go-shop negotiated by the Board potentially truncated the length of the go-shop process, which already was on the short side. Clearly, the Chancery Court will examine each aspect of a sales process, including the terms of a go-shop, in totality. If it is not satisfied, the Chancery Court may very well turn to its own DCF analysis to arrive at fair value under DGCL § 262.