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# Chancery Court Cites Flawed Process in its Resort to Traditional Valuation Methodology and Reliance on all Relevant Factors in a Recent Appraisal Action

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The Delaware Court of Chancery determined that a flawed deal process kept the merger price from being a reliable indication of value in the Blueblade Capital Opportunities LLC and Blueblade Capital Opportunities CI LLC (collectively, "**Blueblade**") v. Norcraft Companies, Inc. ("**Norcraft**") (*C.A. No. 11184-VCS (Del. Ch. July 27, 2018))*, appraisal action.

This action arises out of the acquisition of Norcraft by Fortune Brands Home and Security, Inc. ("**Fortune**") in May of 2015. Norcraft, a cabinetry manufacturer, was a relatively newly publicly traded entity, having its initial public offering in 2013. The company was thinly traded due to its niche market and was sparsely covered by analysts. In October of 2014, Fortune's financial representatives contacted Mark Buller ("**Buller**") the CEO and a member of the Board of Directors of Norcraft. Buller initially responded that Norcraft was not for sale but that he would communicate the proposal to Norcraft's board and also advised the representative that if a deal was reached he would like to be employed by the post-merger company. This would be a repeated request during the deal process even as Buller served as the lead negotiator for Norcraft.

Eventually, Norcraft and Fortune signed a Merger Agreement and a tender process commenced with the per share price of the deal at closing landing at $25.50. Notably, this was a price originally rejected because it was deemed insufficient by the Board of Directors. Throughout the deal process, the evidence demonstrated that Buller appeared more interested in securing himself a post-merger employment position and receiving payment under a tax receivable agreement, where certain shareholders would be paid a significant percentage of applicable annual tax savings in the event of a change in control, rather than securing the best possible offer from Fortune.

In June of 2015, Petitioners filed for appraisal of their shares Norcraft common stock pursuant to the Delaware appraisal statute, Section 262 of the Delaware General Corporation Law (DGCL). Pursuant to Section 262 of the DGCL, the Court is directed to determine the fair value of shares, exclusive of the value attributable to a merger or consolidation, to be paid to shareholders dissenting to a transaction. Delaware courts are required to conduct an independent evaluation of fair value at the time of a transaction. The statute gives the Court a great deal of discretion in considering all relevant factors based on the evidentiary record and sound financial principles to determine the fair value of an entity at the time of the transaction. While the merger price has been embraced as the most persuasive evidence of fair value, Delaware courts have declined to proclaim a presumption in favor of deal price being the determining factor of fair value. The weight given a sales price is dependent upon whether or not the sale results from a robust market check. This is one of the areas in which the Norcraft process was found to be deficient.

First, the Court found that there was no pre-signing market check. While Delaware courts have expressed the opinion that the collective view of sophisticated parties is a superior indicator of market value, to that of a paid expert, Norcraft did not have the benefit of a robust market check to validate the merger price. No other acquirors were sought by Norcraft, or its advisors, Citigroup, in order to increase its leverage to achieve a higher sales price. The company had not had a long trading history having recently gone public and being thinly traded, and Fortune negotiated several deal protection measures including, a $15 million break up fee, an unlimited right to match any superior offer, and the right to launch the tender during the go shop period, that countered the effectiveness of the go shop provision which was meant to act as a fail safe for a meaningful market check. Instead, Norcraft relied completely on Citigroup to oversee the process even though the lead banker had never run a sell-side go shop. Perhaps the most troubling piece of evidence was Fortune's working to actively dissuade a potential bidder who emerged in the process. Lastly, even though the rest of the Board of Directors [just for consistency with above usage] was aware of Buller's conflict of interest, there were no steps taken to ensure the integrity of his role in the deal. No competing bids were received at any point during the merger process and the deal closed at the $25.50 offer price the Norcraft board initially believed to be inadequate.

The Court found the deal process in this action to be significantly flawed because (1) Norcraft failed to perform any market-checks prior to signing the merger agreement in an effort to determine what would constitute a reasonable offer; (2) the lead negotiator had personal motives to ensure the deal closed and nothing was done to mitigate the known conflict of interest; (3) Norcraft also failed to seek out other potential merger partners to ensure negotiations yielded a price reflective of the market and (4) the "go-shop" period, the last opportunity for a market-check, was rendered ineffective by the several deal-protection methods. While these flaws independently may not have led the Court to the same decision, the presence of them all resulted in a transaction where the price was driven by a flawed process and not the market. Furthermore, lack of trading history and analyst coverage meant that the efficient market hypothesis previously embraced by the Delaware courts also failed to support the finding that the deal stock price would be a strong indicator of Norcraft's value.

Once the Court decided to determine the valuation of Norcraft using a traditional valuation method grounded in the evidence and accepted financial principles, the discounted cash flow (DCF) method was chosen. The Court pieced together the most reliable parts of each of the expert witnesses' analysis to craft its own calculation. The Court then used the merger price as a "reality check" and concluded the fair value of the Norcraft shares as of the date of the transaction was $26.16 per share, a $0.66 difference between the deal price and the Court's determination. This was far less than the $34.78 claimed by Blueblade and serves to underscore the Court's focus on the elements of the deal process as the defining aspects of this ruling.

Blueblade Capital Opportunities LLC etc. v. Norcraft Companies, Inc., memorandum opinion 180727 (1 of 2)

Blueblade Capital Opportunities LLC etc. v. Norcraft Companies, Inc., memorandum opinion 180727 (2 of 2)

Rashida Stevens also contributed to this piece.