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Delaware Supreme Court Reverses Court of Chancery Appraisal Decision and Directs Greater Reliance on Deal Price

In a recent decision in *DFC Global Corporation* v. *Muirfield Value Partners, L.P.*, the Delaware Supreme Court, in an opinion by Chief Justice Strine, reversed and remanded the Court of Chancery's determination of the fair value of DFC Global Corporation, which had been found to be $10.30 per share (approximately 8% more than the merger price). Although the Supreme Court declined to create a presumption that deal price is the best evidence of fair value in arm's-length mergers, the court found that the Court of Chancery erred in not giving greater weight to the deal price, and suggested that the deal price was the most reliable indication of fair value, given the robust sale process. The Supreme Court also rejected the Court of Chancery's seeming recognition of a "private equity carve out," in which the deal price in a private equity transaction is viewed as an unreliable indication of fair value due to the firm's goal of achieving a specified rate of return.

Background

DFC Global Corporation provides alternative financial services, particularly payday loans. In the years leading up to its acquisition by Lone Star Fund VIII (U.S.), L.P., it experienced rapid growth and expansion, but also faced strong regulatory headwinds in its main markets, especially the United Kingdom.

In 2012, the company engaged a banker to explore strategic alternatives, who reached out to 41 financial sponsors and three strategic buyers over the course of approximately a year. In the autumn of 2013, the company attempted to refinance about $600 million in its senior notes, but failed due to insufficient investor interest.

Around the same time as the attempted refinancing, DFC renewed discussions with potential buyers, eventually receiving nonbinding indications of interest from Lone Star and another potential buyer. After the company provided the potential buyers with revised management projections that lowered its projected fiscal year 2014 EBITDA, Lone Star decreased its offer from $12.16 to $11.00 per share and requested a 45-day exclusivity period. It cited threatened and actual regulatory changes, the revised projections, reduced availability of acquisition financing, stock price volatility and a weak value in the Canadian dollar (one of DFC's main markets) as reasons for reducing its offer. A few days later, the other potential buyer indicated that it was no longer interested in pursuing a transaction because of DFC's regulatory exposure in the United Kingdom. Shortly thereafter, DFC entered into an exclusivity agreement with Lone Star.

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After receiving projections with further downward revisions, Lone Star again reduced its offer to $9.50 per share, citing similar reasons as for the earlier price reduction and a newly disclosed class action suit against the company. The board approved the merger with Lone Star at $9.50 per share and the merger closed in June 2014. The day after announcing the merger, DFC further reduced its 2014 fiscal year adjusted EBITDA projections, which it ultimately did not meet.

Court of Chancery Opinion

Former DFC stockholders brought an action seeking appraisal of the fair value of their shares. The Court of Chancery's post-trial opinion regarding the fair value of DFC's shares focused on resolving disputes around the appropriate inputs for the discounted cash flow analysis. When considering the deal price as an indication of fair value, it found that (i) the transaction resulted from a robust market search that lasted about two years in which financial and strategic buyers had an open opportunity to buy without inhibition of deal protections; (ii) the company was purchased by a third party in an arm's-length sale; and (iii) there was no hint of self-interest that compromised the market check. Nonetheless, the court noted that "market price is informative of fair value only when it is the product of not only a fair sale process, but also of a well-functioning market," so the Court of Chancery used the deal price as one measure of DFC's value but did not afford it full weight. Instead, the court expressed doubt about each fair value input (i.e., deal price, discounted cash flow analysis and comparable companies analysis). The court's concern largely stemmed from the "tumultuous environment" caused by the regulatory uncertainty leading up to the time of the merger. Despite these doubts, the court noted that each provided "meaningful insight" into DFC's value, and without detailed explanation, determined to provide each with one-third weight in determining fair value, thereby reaching a fair value for DFC of $10.21 per share.

In reargument, the Court of Chancery acknowledged that it had used the wrong working capital numbers in its discounted cash flow valuation. Rather than simply correcting the working capital estimates in its valuation, however, the Court of Chancery, based on an argument from the petitioners that the working capital estimates must correlate with the perpetuity growth rate, upwardly revised the perpetuity growth rate used in its discounted cash flow valuation from 3.1% to 4.0%. With these changes, the court reached a fair value for DFC of $10.30 per share.

Supreme Court Opinion

On appeal, the Delaware Supreme Court reversed and remanded the decision of the Court of Chancery based on the following holdings:

- *Because it could not do so due to the requirements of the Delaware appraisal statute itself, the Supreme Court declined to establish a presumption that the deal price is the best evidence of fair value in arm's-length mergers.* The Supreme Court, citing prior Delaware precedent expressly declining to create such a presumption, pointed to language in Delaware's appraisal statute requiring

that the Court of Chancery consider "all relevant factors" and that "fair value" entails "the value to the stockholder as a going concern." This language, the court found, did not allow for the establishment of such a presumption, although the court noted that the General Assembly could amend the appraisal statute to create such a presumption if appropriate.

- *Despite declining to adopt such a presumption, the Supreme Court held that, because the Court of Chancery determined that the sales process was robust and conflict-free, it erroneously reduced the weight of the deal price in its fair value determination based on factors that were not supported by the record.* In determining not to sustain the Court of Chancery's decision to give only one-third weight to the deal price, the Supreme Court disagreed with both factors cited by the Chancellor as justification for such reduced reliance:

  - The Supreme Court rejected the Chancellor's finding that the deal price was unreliable because DFC was in a trough with future performance dependent upon the outcome of regulatory action. The Supreme Court noted that the market's assessment of future cash flows necessarily considers regulatory (and other types of) risk. Indeed, the court cited evidence in the record suggesting that the market factored regulatory risk into DFC's pricing. For example, the evidence showed that the potential for regulatory risk caused potential buyers to drop out of the sales process. Regulatory risk also contributed to DFC's inability to refinance its notes and caused the company to lower its projected EBITDA, which in turn led to Lone Star losing $100 million in financing for the deal and therefore reducing its offer for the company.

  - The Supreme Court ended speculation over the validity of a "private equity carve out" by rejecting the Court of Chancery's determination that the deal price was unreliable because it was established by a private equity firm that requires a specific rate of return. The Supreme Court noted that all disciplined buyers—both strategic and financial—have internal rates of return that they expect from an investment of capital, and the fact that "a buyer focuses on hitting its internal rate of return has no rational connection to whether the price it pays as a result of a competitive process is a fair one." The fact that lenders would not finance the deal at a higher price also was not supportive of the Court of Chancery's view; to the contrary, the court noted that if "lenders fear getting paid back, then it is not a reason to think that equity is being undervalued."

- *The record did not support the Court of Chancery's decision to increase the company's perpetuity growth rate used in its discounted cash flow analysis.* The Supreme Court listed numerous reasons for this conclusion, including that:

  - Linking the projected working capital in the management's projections to the company's perpetuity growth rate was methodologically suspect and not supported by the projections themselves or testimony about them;

  - The increase in perpetuity value failed to take into account that the company and its industry had already experienced nearly a generation of rapid growth, and the petitioner's assertion that the company was primed for another period of rapid growth was not grounded in any evidence;
  - The company was experiencing strong regulatory pushback, which was affecting its profitability and working capital; and
  - The petitioners' assertion that the perpetuity growth rate should be linked to the working capital estimates was at tension with several of their expert's own assumptions.

- *The Court of Chancery did not err in giving weight to the comparable companies analysis in its determination of fair value.* In their cross-appeal, petitioners argued that the Court of Chancery's comparable companies analysis was unreliable because (i) it relied on metrics from "trough years," (ii) it was based on median financials from multiple years rather than from a single year, which would produce "wildly" different results, and (iii) none of the companies used in the analysis were in fact peers of the company. The Supreme Court disagreed with each of these arguments, noting that the first argument was based on the unsupported premise that the company was poised for substantial growth following the alleged "trough years," as well as unsupported economic principles that market-based insights into value are unreliable in downturns or because of regulatory change. Similarly, the Supreme Court found that if the company was truly in a period of volatile performance, the Court of Chancery's use of median financials from multiple years was a reasonable way for it to be more accurate as to DFC's future performance, rather than guessing what single year would be the most representative. Finally, the six companies used as peers in the Court of Chancery's comparable companies analysis were a subset of the seven companies used by the petitioners' own expert. The Supreme Court also disagreed with petitioners that the Court of Chancery should have given more weight to the discounted cash flow analysis than the comparable companies analysis, as there were ample reasons for the Chancellor to doubt the reliability of the discounted cash flow model on the record.

- *The Court of Chancery erred in not explaining its decision to give one-third weight to each of the deal price, the discounted cash flow valuation and the comparable companies analysis.* The Supreme Court noted that while exercising its considerable discretion in determining fair value in appraisal decisions, the Court of Chancery must "also explain[], with reference to the economic facts before it and corporate finance principles, why it is according a certain weight to a certain indicator of value." Here, the court did not provide such an explanation and this was "in tension with the Court of Chancery's own findings about the robustness of the market check."

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