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DFC Global: Delaware Supreme Court Emphasizes Role of the Market in Certain Appraisal Proceedings

By John Mark Zeberkiewicz and Robert B. Greco

The number of proceedings under Section 262 of the Delaware General Corporation Law (DGCL), in which stockholders who have not voted in favor of a merger and have otherwise perfected their right to seek a judicially determined assessment of the "fair value," in cash, of their shares,[1] has increased significantly over the past few years,[2] providing the courts with additional opportunities to explore the appropriate methods of assessing fair value. Although Section 262 of the DGCL expressly provides that the Court of Chancery, in assessing fair value, "shall take into account all relevant factors,"[3] a trend has emerged, principally in third-party transactions in which the target corporation was shopped, in which the Court has given significant (if not exclusive) weight to the deal price in appraising the shares subject to the proceeding.[4]

In *DFC Global Corp. v. Muirfield Value Partners, L.P.*,[5] the Delaware Supreme Court provided guidance on the use of deal price as a factor to be considered in assessing the fair value of shares in an appraisal proceeding. The Supreme Court reversed and remanded the Delaware Court of Chancery's ruling in *In re Appraisal of DFC Global Corp.*,[6] in which the lower court, in assessing fair value, relied on "a blend of three imperfect techniques," namely a discounted cash flow analysis, the respondent's comparable companies analysis, and the deal price. The Chancery Court gave each methodology equal weight and arrived at a price of $10.21 per share, which was far below the value of $17.90 per share that the petitioners' expert's discounted cash flow analysis would have yielded but still above the $9.50 per share merger consideration.[7]

On appeal, the Delaware Supreme Court stated that the respondent had made "convincing case-specific" arguments for reversing the Chancery Court's assessment of fair value—principally, that the lower court had found that the transaction was the result of a two-year market check in which financial and strategic buyers were invited to submit bids and that the target was acquired by a third-party buyer in an arm's-length transaction.[8] Although stating specifically that "there is no presumption in favor of the

John Mark Zeberkiewicz *is a director, and* **Robert B. Greco** *is an associate, at Richards, Layton & Finger, P.A., in Wilmington, DE. The views expressed herein are those of the authors and are not necessarily the views of Richards, Layton & Finger or its clients.*

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deal price" in an appraisal proceeding, the Supreme Court indicated that in circumstances similar to those at issue in *DFC*, deal price tends to represent the best evidence of fair value.[9] As the Chancery Court only provided one-third weight to deal price, the Supreme Court reversed and remanded its ruling.

Background

The respondent, DFC Global, was a publicly traded payday lending company with operations spanning multiple jurisdictions. Accordingly, DFC was subject to oversight from multiple regulatory authorities and frequently was unable to predict which existing and potential regulations would affect its business. Indeed, the Chancery Court found that, beginning in 2012, regulatory changes in the United Kingdom and in the United States created significant uncertainty with respect to DFC's market position and profitability.[10]

In the face of the increased regulatory uncertainty, high leverage, and questions regarding its management succession plan, DFC engaged a financial advisor to assist in a potential sales process. The process initially was focused on financial buyers, but was eventually expanded to include strategic buyers. Of the multiple potential bidders that were contacted, in late 2013, J.C. Flowers and Lone Star, the ultimate prevailing bidder, submitted indications of interest, at $13.50 and $12.16 per share, respectively.

Subsequently, DFC's board approved revised sets of projections, which lowered the company's forecast on several key metrics. As a result, and in light of other factors such as regulatory issues and a diminished market for acquisition financing, Lone Star reduced its offer. DFC ultimately accepted Lone Star's $9.50 per share offer.

The Chancery Court's Analysis

The Chancery Court reviewed in detail three metrics for arriving at fair value—discounted cash flow, comparable companies and deal price. Each method, according to the Court, suffered from a fundamental limitation attributable to the "tumultuous environment," stemming primarily from regulatory uncertainty, in which DFC was operating in the period preceding the sale.[11] The Chancery Court determined that the uncertainty affected DFC's projections, thus diminishing the reliability of the discounted cash flow analysis.[12] Similarly, the Chancery Court found that the regulatory uncertainty affected the multiples-based comparable companies analysis, a valuation methodology that relies in part on management's projected EBITDA.[13] Finally, as there was a potential that DFC was operating in a "trough" period, the Court determined that deal price was not necessarily indicative of fair value, despite the robust market check.[14]

Nevertheless, the Chancery Court found that each of the methodologies, although individually flawed, fell within a range of reasonableness and thus provided "meaningful insight" into DFC's value.[15] Given the various uncertainties, the Chancery Court determined that it would be appropriate to give each equal weight in arriving at the fair value of the shares subject to appraisal.[16]

The Delaware Supreme Court's Reversal

On appeal, DFC's central argument was that the Chancery Court erred by failing to give "presumptive and exclusive" weight to deal price.[17] DFC further argued that, in light of DFC's robust strategic review process, the lack of conflicts of interest, and other factors, the Chancery Court abused its discretion in assigning deal price only one-third of the weight. Moreover, DFC argued that the notion that the regulatory uncertainty prevented a valuation of DFC was not supported by the record.

The Supreme Court first addressed the issue that it concluded was raised on appeal but not at the lower court: the argument that deal price should be the presumptive indicator of fair value in an appraisal proceeding that follows a merger resulting from a third-party deal involving a market check. Although the Supreme Court was reluctant to consider the argument since it believed it was not properly presented to the lower court, it stated that, even if the issue were fairly presented, it was not persuaded to adopt the position. To this point, the Supreme Court echoed its prior ruling in *Golden Telecom, Inc. v. Global GT LP*,[18] in which the Court focused on the key language in Section 262 directing the Chancery Court to consider "all relevant factors" in assessing fair value to reject a similar argument.[19] Despite acknowledging that it had "little quibble with the economic argument that the price of a merger that results from a robust market check, against the back drop of a rich information base and a welcoming environment for potential buyers, is probative of the company's fair value," the Supreme Court saw "no license in the statute" for the creation of a presumption that it is either the exclusive, best, or primary evidence of fair value.[20]

But the Supreme Court's decision not to cabin the appraisal process did not

> in any way signal [its] ignorance to the economic reality that the sale value resulting from a robust market check will often be the most reliable evidence of fair value, and that second-guessing the value arrived upon by the collective views of many sophisticated parties with a real stake in the matter is hazardous.[21]

Rather, the Supreme Court recognized that, in assessing value, market prices tend to be considered superior to other valuation techniques because they constitute a distillation of the informed views of the market participants.[22] As the Supreme Court noted,

> corporate finance theory reflects a belief that if an asset—such as the value of a company as reflected in the trading value of its stock—can be subject to close examination and bidding by many humans with an incentive to estimate its future cash flows value, the resulting collective judgment as to value is likely to be highly informative and that, all estimators having equal access to information, the likelihood of outguessing the market over time and building a portfolio of stocks beating it is slight.[23]

In considering these economic principles in conjunction with Section 262's purpose, the Supreme Court explained that "fair price" is not the highest financeable price or the highest price a party would be willing to pay but is instead "the price at which a reasonable seller, under all circumstances, would regard as within a range of fair value; one that such a seller could reasonably accept."[24] In the Court's view, this was underscored by "real world evidence regarding public company M & A transactions" since "buyers in public company acquisitions are more likely to come out a loser than the seller."[25]

Applying this principle, the Supreme Court refuted each of the bases upon which the Chancery Court relied to diminish the role of deal price in determining fair value. In rejecting the argument that deal price was unreliable due to uncertainty surrounding DFC's future performance pending the outcome of regulatory actions, the Supreme Court observed that markets are apt at pricing this sort of regulatory risk.[26] The Supreme Court further found that the fact that Lone Star, a private equity firm, required a specific rate of return in connection with its acquisition of DFC did not render deal price unreliable since "all disciplined buyers, both strategic and financial, have internal rates of return that they expect in exchange for taking on the large risk of a merger."[27] "Especially untenable," in the Supreme Court's view, was the idea that deal price could not be reliable because lenders would not finance an acquisition by Lone Star at a higher price.[28] As creditors are paid before equity holders, their fear of repayment provided no reason to think that the equity was undervalued.[29]

Moreover, the Supreme Court held that the Chancery Court failed to sufficiently articulate its decision to give each of the three metrics it used one-third weight.[30] Although the Chancery Court has "considerable discretion" in determining how to calculate "fair value," the Supreme Court clarified that the Chancery Court must exercise this discretion "while also explaining, 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."[31]

In light of these findings, the Supreme Court reversed and remanded the case to the Chancery Court to reassess its fair value determination in light of the Supreme Court's decision.

Conclusion

Although the Supreme Court's decision in *DFC* declined to create a presumption in favor of deal price, the Supreme Court indicated that the discretion afforded to the Chancery Court in appraisal proceedings should be exercised in accordance with economic and corporate finance principles. In connection with third-party acquisitions of public companies following a thorough sales process, this may require a considerable weighting of deal price, particularly where comparable companies and discounted cash flow analyses may be unreliable.

Notes

1. 8 *Del. C.* § 262.
2. Charles R. Korsmo & Minor Myers, *Appraisal Arbitrage and the Future of Public Company M&A*, 92 Wash. U. L. Rev. 1551 (2015).
3. 8 *Del. C.* § 262(h).
4. *See, e.g., In re Appraisal of PetSmart, Inc.*, 2017 WL 2303599 (Del. Ch. May 26, 2017); *Merion Capital LP v. BMC Software, Inc.*, 2015 WL 6164771 (Del. Ch. Oct. 21, 2015); *In re Appraisal of Ancestry.com, Inc.*, 2015 WL 399726 (Del. Ch. Jan. 30, 2015).
5. — A.3d —, 2017 WL 3261190 (Del. Aug. 21, 2017).
6. 2016 WL 3753123 (Del. Ch. July 8, 2017).
7. *Id.* at *1.
8. 2017 WL 3261190, at *1.
9. *Id.*
10. 2016 WL 3753123, at *21.
11. *Id.*
12. *Id.* at *22.
13. *Id.* at *23.
14. *Id.* at *22.
15. *Id.* at *23.
16. *Id.*
17. 2017 WL 3261190, at *12.
18. 11 A.3d 214 (Del. 2010).
19. 2017 WL 3261190, at *13–14.
20. *Id.* at *15.
21. *Id.*
22. *Id.* at *18.
23. *Id.*
24. *Id.*
25. *Id.* at *19.
26. *Id.* at *20.
27. *Id.* at *22.
28. *Id.* at *23.
29. *Id.*
30. *Id.* at *31.
31. *Id.*