August 4, 2017

Delaware Supreme Court Reverses DFC Global Appraisal Decision

Court Finds That Merger Price Following Robust, Conflict-Free Sale Process is the Best Evidence of Fair Value, and Rejects "Private Equity Carve Out" Adopted by Court of Chancery

SUMMARY

In *DFC Global Corp.* v. *Muirfield Value Partners, L.P.*, the Delaware Supreme Court reversed and remanded the Court of Chancery's appraisal decision arising out of the 2014 acquisition of DFC Global by private equity firm Lone Star Funds, in which the Court of Chancery had determined that the "fair value" of DFC Global was $10.30 per share, $0.80 above the merger price.[1] The Court rejected competing arguments by the company and the petitioner, respectively, that an appraisal court should give exclusive or presumptive weight either to the deal price or to a discounted cash flow ("DCF") valuation. Instead, while confirming the Court of Chancery's statutory discretion to take into account all relevant factors and recognizing no presumption in favor of the deal price, the Supreme Court found that economic principles suggest that the price achieved in a robust and unconflicted sale process is the best evidence of fair value. The Supreme Court rejected the Court of Chancery's decision to give equal weight to the merger price, DCF value and a comparable companies valuation in arriving at fair value. Although the Court of Chancery retains discretion to employ multiple valuation methods and accord weight to each, the Supreme Court held that any weighting must be grounded on the record before the court, and the Court suggested strongly that the record here did not support any deviation from the merger price.

Importantly, the Supreme Court rejected two reasons cited by the Court of Chancery for discounting and deviating from the merger price. First, the Court dispensed entirely with the so-called "private equity carve out," by which the Court of Chancery suggested that a deal price resulting from a transaction with a private equity buyer is not a reliable indication of value because private equity buyers are price

constrained by desired internal rates of return. Second, the Supreme Court rejected the Court of Chancery's conclusion that the deal price here was potentially unreliable due to regulatory and business risks facing the company, finding that the uncertain value implications of those risks was a reason to give more, not less, weight to the collective value judgment of the market as reflected in the deal price.

The decision, while declining to adopt a bright-line rule in favor of the merger price in an appraisal proceeding, suggests that the Court of Chancery should give substantial if not exclusive weight to a deal price that follows a vigorous and conflict-free market check and in the absence of external influences, such as a controlling stockholder. The Supreme Court noted that "second-guessing [that] value . . . is hazardous," pointing out the many cases where the Court of Chancery in its discretion has given the deal price "predominant and indeed exclusive weight." Although the Delaware courts are likely to provide additional clarity on the appraisal standards in other pending important matters, including the pending appeal of the appraisal relating to Dell Inc.,[2] the *DFC Global* decision suggests that appraisal awards in excess of the deal price following a thorough and reliable sale process should be increasingly rare.

BACKGROUND

On April 2, 2014, DFC Global Corporation ("DFCG") announced that it had entered into a merger agreement with funds affiliated with Lone Star (the "Merger"), through which Lone Star would acquire all of DFCG's outstanding shares for $9.50 per share. The Merger followed a two-year sale process involving more than 35 financial sponsors and three strategic bidders. DFCG is a provider of alternative consumer financing, primarily in the form of payday loans, in the United Kingdom, Canada, and the United States. DFCG experienced significant growth in the years leading up to the sale process, but it also faced significant and increasing regulatory scrutiny before and during the sale process, which contributed to difficulties refinancing certain indebtedness in late 2013.

DFCG's sale process began in the Spring of 2012 with an outreach to six financial buyers. Three firms expressed potential interest and conducted due diligence, but lost interest by October 2012. Thereafter, DFCG's financial advisor reached out to thirty-five more financial buyers and three strategic buyers. The sale process had been underway for more than 18 months before Lone Star expressed an interest in October 2013. At the same time, DFCG was in discussions with another financial buyer that had previously expressed an interest. In December 2013, Lone Star and the other putative buyer provided expressions of potential interest at $12.16 per share and $13.50 per share, respectively. After DFCG materially reduced its fiscal year ended June 2014 projected earnings in February 2014, Lone Star reduced its offer to $11.00 per share, and other bidder dropped out. DFCG twice more reduced its June 2014 projections during March 2014, and DFCG and Lone Star ultimately agreed on April 1, 2014 to a merger at $9.50 per share. In its fiscal year ended June 2014, DFCG missed its latest earnings projections, provided at the end of March 2014, by 10%.

Stockholders owning approximately 4.6 million DFCG shares filed a petition in the Court of Chancery seeking fair value for their shares under the Delaware appraisal statute. Petitioners claimed that the fair value of their shares was $17.94 per share based solely on a DCF analysis, or almost 90% above the deal price. DFCG contended that fair value was $7.94 per share based upon a combination of a DCF analysis and a comparable companies valuation, or, alternatively, the $9.50 per share deal price.

In a July 8, 2016 decision, the Court of Chancery declined to find that the deal price equated to fair value. Although recognizing that Delaware courts typically defer to a merger price where, as here, the transaction was the product of an arm's-length process and a robust bidding environment, the court reasoned that the market conditions leading to the transaction were not reliably conducive to achieving a fair price because of uncertainties in DFCG's business, and pricing constraints inherent in private equity buyers' need to achieve self-imposed internal rates of return. The court also found reasons to distrust the DCF and comparable company valuations proffered by the litigants, and concluded that "the most reliable determinant of fair value of [DFCG's] shares is a blend of three imperfect techniques," giving equal weight to the deal price, a revised DCF analysis and a comparable company valuation.[3] The court initially ruled that this technique yielded a valuation of $10.21 per share. After both sides sought reconsideration of the decision, the court made certain adjustments, and awarded $10.30 per share as fair value.

THE SUPREME COURT DECISION

In its August 1, 2017 decision by Chief Judge Leo Strine, the Delaware Supreme Court reversed and remanded, disagreeing with several of the core rulings that led the Court of Chancery to a fair value price above the deal price.

First, the Supreme Court addressed competing arguments that were not presented to the Court of Chancery: Whether the court should give conclusive or presumptive weight either to the deal price or to a DCF valuation. Chief Judge Strine held that both bright-line rules were inconsistent with its precedent and with the express language of the appraisal statute requiring that the Court of Chancery consider "all relevant factors" in determining fair value.[4]

Second, although declining to adopt any presumption in favor of the deal price, the Court ruled that "[m]arket prices are typically viewed superior to other valuation techniques because, unlike, *e.g.*, a single person's discounted cash flow model, the market price should distill the collective judgment of the many based on all the publicly available information about a given company and the value of its shares."[5] The Court observed that deal prices often are overly generous, "as competitive pressures often have resulted in buyers paying prices that are not justified by their ability to generate positive return on the high costs of acquisition and of integration."[6] "Because the Court of Chancery found that the sales process was robust and conflict-free," Chief Judge Strine found insufficient reason to justify giving the deal price merely one-third weight.

Third, the Supreme Court found both reasons cited by the Court of Chancery for doubting the reliability of the merger price to lack economic or factual support. The Supreme Court ruled that "[t]he 'private equity carve out' that the Court of Chancery seemed to recognize, in which the deal price resulting in a transaction won by a private equity buyer is not a reliable indication of fair value, is not one grounded in economic literature or this record."[7] Chief Judge Strine reasoned that all buyers are constrained to pay a price that will allow a return on the investment, and the fact that a financial buyer demands a certain return "does not mean that the price it is willing to pay is not a meaningful indication of fair value," at least where, as here, the record supports the fairness of the price. And, the Court concluded that the business and regulatory uncertainties and risks facing the Company were insufficient reasons to undercut the efficacy of the sale process. While "the market's collective judgment of the effect of regulatory risk may turn out to be wrong, . . . the collective judgment of the many is more likely to be accurate than any individual's guess," and the existence of those uncertainties is reason to give more, not less, weight to the collective value judgment of the market as reflected in the deal price.[8]

Finally, after finding factual and economic errors in the manner in which the Court of Chancery calculated its revised DCF valuation following the parties' requests for reconsideration, the Supreme Court rejected the Court of Chancery's decision to give equal weight to the merger price, DCF value, and a comparable companies valuation calculating fair value. Although expressing sympathy for the task of the Court of Chancery when faced with widely varying positions on valuation that might tempt the court to employ the "improvisational" simplicity of a mathematical formula, the Supreme Court ruled that any weighting of valuation metrics must be based upon "the economic facts before it and corporate finance principles."[9]

IMPLICATIONS

The Delaware Supreme Court's reversal and remand of the Court of Chancery's decision provides some useful guidance to Court of Chancery judges tasked with the unenviable obligation of pinpointing fair value "[w]hen faced with briefs and expert reports written by highly skilled litigators in concert with men and women of valuation science that often come to ridiculously varying positions."[10]

- The *DFC Global* decision reiterates the preeminence of the merger consideration as an indicator of fair value in a transaction that was the product of a reasonable market check untainted by conflicts or other external influences.
- The Court suggests that there is even greater reason to defer to the deal price in respect of companies having uncertain prospects or that are otherwise difficult to value. Appraisals of companies of this ilk historically have presented the greatest risk in appraisal cases.
- The Court rejected the "private equity carve out" that had developed in one form or another in a few recent cases, at least where, as in *DCF Global*, "there are objective factors that support the price paid." In that regard, the Court noted that "the absence of synergistic buyers for a company is itself relevant to its value."[11]
- In a lengthy footnote, the Supreme Court suggested that "it is in tension with the statute itself to argue that the subjective view of post-merger value" derived from the buyer's internal valuations "can be used to value the respondent company in an appraisal."[12] Valuation evidence from

buyers and their financial advisors reflecting valuations above the deal price has long been fertile grounds for appraisal petitioners. Chief Judge Strine observed a buyer's "expect[ation] to profit does not mean that the collective view of value that results from the deal price is not a reliable indicator of fair value."

- The decision includes an extensive analysis of various technical aspects of, and inputs into, a DCF valuation model, including the potential need to adjust or otherwise account for potentially implausible assumptions that the company will grow at robust rates in perpetuity.[13] Given the "extensive market check," Chief Judge Strine noted that "the value gap" indicated by a DCF valuation nearly 50% above the deal price "should have given the Court doubts about the reliability of its [DCF] analysis."
- The decision may breathe new life into the use of alternative valuation metrics, such as the comparable companies analysis that was adopted in part by the Court of Chancery and endorsed by the Supreme Court. Although the Court of Chancery may continue to show understandable reluctance to rely upon that method in the absence of a clearly defined universe of comparables, the Supreme Court dispensed with several challenges to the merits of a comparable companies valuation technique in appraisal proceedings.[14]
- The observation by the Court that competitive forces often yield transaction prices in excess of fair value may provide further opportunities for companies to argue for appraisal values below the market price.

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ENDNOTES

[1] *DFC Global Corp.* v. *Muirfield Value Partners, L.P.*, No. 518,2016 (Del. Aug. 1, 2017).

[2] Sullivan & Cromwell LLP, *In re Appraisal of Dell Inc.*, June 13, 2016.

[3] *In re Appraisal of DFC Glob. Corp.*, 2016 WL 3753123, at *1 (Del. Ch. July 8, 2016).

[4] *DFC Global Corp.* v. *Muirfield Value Partners, L.P.*, No. 518,2016, slip op. at 13-14 (Del. Aug. 1, 2017).

[5] *Id.* at 18.

[6] *Id.* at 19.

[7] *Id.* at 2.

[8] *Id.* at 1. Chief Judge Strine reiterated that a "fair value. . . does not mean the highest possible price that a company might have sold for had Warren Buffett negotiated for it on his best day and the Lenape who sold Manhattan on their worst." Instead, it means "what would fairly be given to them in an arm's-length transaction." *Id.* at 18.

[9] *Id.* at 31.

[10] *Id.*

[11] *Id.* at 22 n.154.

[12] *Id.* at 21 n.145.

[13] *Id.* at 24-25.

[14] *Id.* at 8 n.52 & 30-31.

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