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DFC Global: *Delaware Supreme Court Strongly Endorses Reliance on Merger Price in Appraisal Cases Involving an Arm's-Length Merger With a Robust Sale Process—But Declines to Establish an Express Judicial Presumption*

In *DFC Global v. Muirfield* (Aug. 1, 2017), the Delaware Supreme Court, *en banc*, reversed the Court of Chancery's appraisal decision involving the acquisition of DFC Global Corp., a publicly traded payday lending firm, by a private equity firm, and remanded the case for further consideration by the Court of Chancery. In its opinion below, the Court of Chancery had found, following full trial on the merits, that the underlying sales process was robust and competitive. However, the Court of Chancery also found that the extreme regulatory uncertainty facing the target company (specifically, a complete overhaul of the regulatory framework applicable to the company) undermined the reliability, for appraisal purposes, of the market's assessment of DFC Global's value. The Court of Chancery also viewed the regulatory uncertainty as undermining the reliability of the company's projections for a DCF analysis. The Court of Chancery therefore relied on a combination of the merger price, a DCF valuation, and a comparable companies valuation, weighted one-third each, to determine "fair value"—and the result was approximately 8.4% above the merger price.

The Supreme Court, with Chief Justice Strine writing for the court, held that (a) based on the Court of Chancery's factual findings concerning the market check, the Court of Chancery had not provided a sufficient basis for deciding to give only one-third weight to the deal price in the determination of fair value; and (b) the Court of Chancery had erred in adjusting certain of the inputs in its DCF calculation. The Supreme Court reversed the decision and remanded the case back to the Court of Chancery to reconsider the weighting of the various valuation methodologies, given the strong reliability of the merger price in this case as compared to the unreliability of the projections available for a DCF analysis.

Key Points

- **Rejection of an express presumption favoring use of the deal price.** The Supreme Court declined to establish an *express judicial presumption* favoring reliance on the deal price to determine fair value in any specific class of mergers—stating that such a presumption would be inconsistent with the appraisal statute, which requires that the Court of Chancery determine fair value in its discretion, but "taking into account all relevant factors." Any such presumption would require amendment of the appraisal statute by the Delaware General Assembly, the Supreme Court stated.

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- **Strong endorsement of reliance on the deal price in arm's-length cases with a robust sale process.** While it declined to adopt a presumption, the Supreme Court strongly endorsed the deal price as often "the best evidence of fair value" in cases involving an arm's-length merger with a robust sale process. Indeed, the Supreme Court explained: "[O]ur refusal to craft a statutory presumption in favor of the deal price when certain conditions pertain does not in any way signal our 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."

- **Requirement that the Court of Chancery provide an express and supported basis for its weighting of various valuation methodologies.** The Supreme Court emphasized that the Court of Chancery, in determining fair value, must consider the reliability of appropriate factors (such as the merger price and a DCF analysis) and "explain," based on the "economic facts" before it and corporate finance principles, the weight it accords to the results of those methodologies given their relative reliability. Importantly, the Supreme Court stated that the Court of Chancery's "decision to give one-third weight to each [of the three] metric[s] [it utilized] was unexplained and in tension with the Court of Chancery's own findings about the robustness of the market check." Thus, it appears that the extent of the court's reliance on the deal price versus a DCF analysis in any given case should be determined on a continuum, based on how robust the sale process was as compared to how reliable the target company projections available for a DCF analysis are.

- **Rejection of the concept that the regulatory uncertainty facing the target undermined the reliability of the deal price.** Importantly, the Supreme Court suggested that, on remand, the Court of Chancery should reconsider whether, based on the record and economic and corporate finance principles, the merger price may have been the most reliable indicator of fair value in this case. That possibility, the Supreme Court explained, was grounded primarily in the Court of Chancery's findings and holdings that the sale process was robust and the Supreme Court's conclusion, on appeal, that the regulatory uncertainty facing the target company did not undermine the reliability of the merger price because the potential for tighter regulation of the company was known (by the bidders and the market generally) and had been factored into the deal price.

- **Rejection of the concept that a financial buyer's pricing model undermines the reliability of the deal price in an LBO transaction.** The Supreme Court expressly and definitively rejected the concept raised in the opinion below (and in other recent Court of Chancery appraisal opinions) that a merger price derived from an "LBO pricing model"—as the merger price in this case was—may be inherently unreliable as it is based on a required internal rate of return for the buyer rather than the going concern value of the target company.

- **We note that continued increased reliance by the court on the merger price to determine fair value in third-party, arm's length deals should discourage appraisal claims (and, particularly, the practice of appraisal arbitrage)—and, in any event, should drive appraisal claims to cases involving non-arm's length transactions, a flawed sale process and/or unusual facts.** We note below a number of key open issues that the Supreme Court left unresolved in its *DFC Global* opinion—resolution of which could significantly affect the development of appraisal going forward.

Discussion

In the past couple of years, the Court of Chancery has increasingly relied on the merger price as the sole or predominant indication of appraised fair value in cases involving arm's length transactions with a robust sale process. The Court of Chancery has reasoned that, in these transactions, when the sale process included a meaningful market check, the merger price is the best proxy for fair value because it was derived "in the crucible of market reality" by knowledgeable participants with a real financial stake. Indeed, in the eight other appraisal decisions issued since 2015 involving arm's-length transactions, in seven of them, the Court of Chancery relied solely or predominantly on the merger price.

In *DFC Global*, in its opinion below, the Court of Chancery viewed the sale process as robust but rejected sole reliance on the merger price due to the extreme regulatory uncertainty facing the company. The sale process included full shopping of the company over a two-year period and, although private equity firm Lone Star ultimately was the sole bidder, there were no significant impediments to competing bids emerging. At the time of the sale process, however, the payday loan industry was facing a complete regulatory overhaul, with the results of that process and the impact on the company highly uncertain. The business uncertainty was so significant that it led the company to continually, rapidly and significantly revise its projections downward throughout the sale process, to the point that the company ultimately determined that it would be "impractical" to continue to project earnings per share. The Court of Chancery viewed those developments as indicating the absence of information that could provide a substantive basis on which a buyer could determine a merger price or conduct a DCF analysis—therefore, in its view, neither could be fully relied on as an indication of the company's going concern value at that time. Thus, the Court of Chancery relied equally on each of what it characterized as "three imperfect methodologies"—the merger price, a DCF valuation and a comparable companies valuation.

The Delaware Supreme Court found that the regulatory uncertainty had been factored into the merger price. The Supreme Court rejected the Court of Chancery's finding that the regulatory uncertainty led to "the market's assessment of the company's value [being] not as reliable as under ordinary conditions." The Supreme Court reasoned that, while there was a high degree of regulatory uncertainty, the record showed that the bidders and the market generally had known about the potential that the company might become subject to tighter regulation and had "factored it in their assessments of the company's value." Characterizing the payday lending industry as "hardly unusual in being subject to regulatory risks," the Supreme Court noted that the Court of Chancery had "cited no economic literature to suggest that markets themselves cannot price this sort of regulatory risk." Moreover, the Supreme Court stated, "the record revealed that equity analysts, equity buyers, debt analysts, debt providers and others," as well as "potential buyers in the sale process and participants in the debt markets" were in fact "attuned to" and "watching" the regulatory risks facing DFC and had "factored regulatory risk into DFC's price.

The Supreme Court strongly endorsed the merger price as the best measure (albeit not a presumptive measure) of fair value in arm's length mergers with a robust sale process—particularly where the target company projections available for a DCF analysis are unreliable. The Supreme Court, emphasizing the Court of Chancery's findings below that there had been "a robust market search" and "no hint of self-interest that compromised the market check," stated that, under those conditions, "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 profit had a chance to bid." The Supreme

Court noted also that the target company projections available for a DCF analysis were not reliable—as, even after they had been revised downward during the sale process, the company had to revise them further because "it was not keeping pace with them" and the company then still "fell short of meeting them weeks after the transaction closed."

The Supreme Court declined to establish an *express presumption* favoring reliance on the deal price to determine fair value when there was a robust sale process—but, notably, appeared to suggest that there would be little basis for the Court of Chancery to conclude, on remand, that the merger price was not the best indicator of fair value. The Supreme Court explained that the respondent company had argued (for the first time, during the appeal) that the Court should establish "a presumption that in certain cases involving arm's-length mergers, the price of the transaction…is the best estimate of fair value." The Supreme Court stated that it would not, "by judicial gloss," engage in an act of statutory "creation" by establishing such a presumption. The Delaware statute requires, the court noted, that the Court of Chancery "in the first instance [has] the discretion to determine [fair value] by taking into account 'all relevant factors'". The court stated: "[T]hat language is broad, and until the General Assembly wishes to narrow the prism through which the Court of Chancery looks at appraisal value in specific classes of mergers, this Court must give deference to the Court of Chancery if its determination of fair value has a reasonable basis in the record and in accepted financial principles relevant to determining the value of corporations and their stock." Notably, however, the Chief Justice, after directing the Court of Chancery to reconsider the reliability and weighting of the three methodologies it had relied on, strongly suggested that sole or predominant reliance on the deal price could well be appropriate. "On remand," the Chief Justice wrote, "the Chancellor…may conclude that his findings regarding the competitive process leading to the transaction, when considered in light of other relevant factors, such as [the apparent unreliability of the company's projections], suggest that the deal price was the most reliable indication of fair value."

The Supreme Court emphasized that the Court of Chancery must consider the reliability of each of the merger price and a DCF and weight them accordingly. The Supreme Court stated that the Court of Chancery's decision to give one-third weight to each of the deal price, the DCF valuation and the comparable companies analysis "was not explained," and that "the court must explain its weighting in a manner supported by the record before it." Further, the Court stated: "*Given the Court of Chancery's findings about the robustness of the market check and the substantial public information available about the company*, we cannot discern the basis for [the Court of Chancery's] allocation" of one-third of the weight in its determination to each of three valuation methodologies (emphasis added). The Supreme Court characterized the decision to give one-third weight to each metric as being "in tension with the Court of Chancery's own findings about the robustness of the market check." In our view, the implication of the Supreme Court's findings is that the Court of Chancery should rely solely or predominantly on the merger price in cases involving a conflicts-free robust sale process and (as discussed in the next paragraph) unreliable projections.

The decision indicates that, in determining fair value in cases involving arm's-length transactions, the Court of Chancery must expressly determine the relative reliability of the applicable valuation methodologies. When the Court of Chancery first shifted toward increased reliance on the merger price in arm's-length mergers a couple of years ago, it emphasized that it would rely solely on the merger price as the best proxy for fair value only when *both* (i) the nature of the sale process established that the merger price was a particularly reliable indicator of fair value *and* (ii) the target company projections available for a DCF analysis were unreliable, rendering the DCF methodology particularly *un*reliable for a

determination of fair value. By contrast, in more recent cases, the Court of Chancery has sometimes relied solely on the merger price without regard to the reliability of projections (or even when indicating that the projections were reliable). We have discussed in previous Briefings that, while not always doing so expressly, the Court of Chancery appears to determine whether to rely on the merger price and/or a DCF on a continuum based on the relative reliability of each under the specific facts and circumstances. Indeed, even when the Court of Chancery relies solely on the merger price or the DCF, it often looks to the other at least as a "double-check." The Supreme Court decision in *DFC Global* appears to be an endorsement of this approach—but with a requirement, seemingly, that the court expressly consider and provide support for its view of the reliability, and the court's weighting, of both of these approaches (and, if relevant, others). Notably, the Supreme Court clarified that the decision does not preclude reliance solely on the merger price (or another methodology). "In some cases," the Supreme Court wrote, "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." In each case, however, the Court of Chancery must "explain its weighting in a manner that is grounded in the record before it."

The Supreme Court rejected the suggestion in the Court of Chancery opinion that a merger price derived from a financial buyer's "LBO pricing model" is inherently unreliable for fair value purposes. In the decision below (and also in both its *Dell* and *Lender Processing a*ppraisal decisions), the Court of Chancery suggested that a financial buyer's deal price may be inherently less reliable than a strategic buyer's price because the LBO pricing model used by financial buyers focuses on achieving a certain internal rate of return for the buyer and "reaching a deal within [the buyer's] financing constraints," rather than focusing on the target company's "fair value." The Supreme Court dismissed the issue as "not one grounded in economic literature or this record." The Supreme Court wrote: "[T]he fact that a financial buyer may demand a certain rate of return on its investment in exchange for undertaking the risk of an acquisition does not mean that the price it is willing to pay is not a meaningful indication of value." That conclusion is particularly so, the Supreme Court stated, where, as in this case, "the financial buyer was subjected to a competitive process of bidding." (We note that the skepticism expressed about the reliability of financial buyer pricing also has been repudiated in the post-*DFC Global* Court of Chancery decision in *PetSmart*.)

The Supreme Court decision also indicates that determinations that the Court of Chancery makes with respect to a DCF analysis must be justified by an "adequate basis in the record." The Court of Chancery had made a clerical error that, on a motion for reargument, resulted in a need to revise the working capital figures in the court's DCF analysis. Those revisions had the effect of moving the DCF result lower than the deal price. The Court of Chancery then, "at the prompting of the petitioners," increased the perpetuity growth rate that it used (from 3.1% to 4%), which had the effect of moving the DCF result back to close to where it had been above the deal price. "But, no adequate basis in the record supports this major change in growth rate," the Supreme Court stated. The Supreme Court cited the uncertain and "hockey-stick" nature of the out-years of the projections, the fact that the industry had already gone through a period of above-market growth, and the lack of any basis to conclude that the company would sustain high growth beyond the projection period, as indicating the "the record [did] not sustain the…decision to substantially increase the company's perpetuity growth rate in its [DCF] model after reargument."

The Supreme Court rejected the petitioners' argument that the Court of Chancery had abused its discretion by relying in part on a comparable companies analysis. We note that the Court of

Chancery in recent years has generally rejected the use of comparable companies and comparable transactions analyses for determining fair value—typically finding that the comparables are not sufficiently comparable to be reliable. In this case, the Supreme Court noted, "this was a rare instance where both experts agreed on the comparable companies the Court of Chancery used and so did several market analysts and others following the company." Thus, the Supreme Court stated, "giving weight to a comparable companies analysis was within the Chancellor's discretion."

The Supreme Court left unresolved a number of key open appraisal issues.

- **Sole reliance on the merger price.** When the sale process has been robust *and* the projections available for a DCF analysis are *reliable*, can the Court of Chancery rely solely on the merger price—or must it also take into account at least to some extent a DCF result? Would looking to the DCF analysis only as a "double-check" be sufficient in these circumstances—or would the DCF result have to be a specifically "weighted" part of the court's fair value determination? Could sole reliance on the merger price be justified by a view (which the Supreme Court's commentary in *DFC Global* appeared to suggest) that a DCF analysis is possibly *inherently* less reliable than the merger price because of, for example, the inherent uncertainty of all projections, the myriad other subjective and uncertain inputs to a DCF analysis, and the widely divergent DCF results proffered by the parties?

- **Interested transactions.** When a controller is the buyer (or in another "interested" transaction), is it possible for a sale process to be sufficiently robust that the court could rely solely or predominantly on the merger price rather than DCF? (Would compliance with the *MFW* prerequisites satisfy the requirement of a "robust sale process"?)

- **Downward adjustment to exclude the value of synergies.** When the court relies on the merger price, should the Court of Chancery make a downward adjustment to arrive at fair value given the statutory mandate that "any value arising from the merger itself" must be excluded from fair value? If so, would the value of *all* synergies be excludable—or, as Vice Chancellor Glasscock has suggested in *BMC Software*, should *most* synergies *not* be excluded because they could be captured by the company in an acquisition with *any* third party or captured by the company on a standalone basis. In other words, is it only the value of synergies that are "unique" to the specific transaction that would be excluded—*i.e.*, synergies that could not be achieved by the company itself, do not represent value associated with being part of a combined company, and/or are attributable to something unique that *the buyer* brings to the transaction? Would any other value (such as a "control premium" beyond the value of merger synergies) be excludable? We note that the Court of Chancery has repeatedly acknowledged the statutory mandate to deduct from the merger price the value of synergies arising from the merger—but has never made such an adjustment (with one exception where, without discussion, it made a nominal adjustment). The court has been openly grappling with *which* synergies are properly excludable, how to value them, and how to determine the extent to which they were reflected in the merger price. We note that if the court changes course and makes such adjustments, then appraised fair value would virtually always be *below* the merger price when the court relies on the merger price. The Chief Justice in *DFC Global* noted that the issue of deduction of merger synergies was not raised by the parties in this case and his commentary did not appear to resolve any of these open issues.

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