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Delaware high court says a fair deal price should get the most weight in appraisal valuation

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The Delaware Supreme Court recently held in *DFC Global* that the best evidence of fair value in appraisal litigation is a deal price that resulted from an open and competitive sale process informed by robust public information.[1]

The decision reversed a Chancery Court valuation that equally weighted the deal price, valuation based on discounted cash flow and valuation based on comparable company analysis. The ruling is a setback for the arbitrage investors driving the recent boom in M&A appraisal litigation.

Historically, "appraisal rights" have been a sleepy backwater of Delaware corporate jurisprudence.

Section 262 of the Delaware General Corporation Law gives a stockholder dissatisfied with the price being paid in a cash-out merger the right to "dissent" and bring an action for judicial determination and payment of the fair value of such stockholder's stock, exclusive of any synergies or benefits that result from the merger. In determining fair value, the court is to take into account all relevant factors.[2]

Appraisal was intended to be remedial in nature, to balance the majority stockholder rule against the need to protect the minority stockholder.

The dissenting stockholder is compensated for the true or intrinsic value of what is taken in the merger. Therefore, the value of the stock is determined on a going-concern basis.

The Chancery Court historically placed substantial weight on discounted cash flow analysis as the most reliable indicator of going-concern value.[3]

NO LONGER BACKWATER LITIGATION

In the past few years, however, sophisticated investors have developed an arbitrage strategy of buying the target company stock after the merger is announced and then bringing an appraisal action contending that fair value based on discounted cash flow or other valuation methodologies exceeds the deal price.

The strategy resembles buying a lottery ticket with a guaranteed minimum payout equal to the purchase price.

Companies have a substantial incentive to settle by offering the dissenting stockholders a premium because of the substantial cost of litigating the suits and the unpredictability of the Chancery Court's ruling based on complex and conflicting valuation testimony from expert witnesses. A recent study estimates that appraisal litigation is currently pursued in 25 percent of eligible deals — and that 80 percent of such cases settle.[4]

A significant line of Chancery Court cases has emerged in this area. These decisions have held that the highest price — as determined by the free market following a robust, well-run sale process — rather than the testimony of paid experts without any economic skin in the game is the best evidence of "fair value."[5]

However, other cases follow the statutory mandate that the Chancery Court perform an independent evaluation and take into account all relevant factors and the Delaware Supreme Court's prior, explicit rejection of any rule requiring the Chancery Court to defer to the merger price.

Historically, "appraisal rights" have been a sleepy backwater of Delaware corporate jurisprudence.

These cases apply a combination of valuation approaches, including discounted cash flow, which sometimes produces a fair value substantially higher than the deal price, thereby providing a jackpot for the arbitrage investor.[6]

NEW SUPPORT FOR DEAL PRICE

Chief Justice Leo E. Strine's recent opinion in *DFC Global* will reshape the valuation methodology used in appraisal proceedings.

As a practical matter, it will also encourage the Chancery Court to accept the deal price for publicly traded companies unless the Chancery Court can identify material flaws in the sale process or conflicts of interest that taint the process.

The *DFC Global* opinion declined to explicitly establish a presumption that in cases involving an arm's-length merger of a publicly traded company, the price of the transaction giving rise to the appraisal rights is the best evidence of fair value.

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However, the Delaware Supreme Court's reversal of the Chancery Court's prior valuation, which equally weighted the transaction price, a discounted cash flow analysis and a comparable companies analysis, suggests the deal price should be the lodestar for appraisal proceedings absent unusual circumstances, such as a conflict of interest or related party transaction.

The effect, if not the intent, of *DFC Global* will be to push back against the current boom in M&A appraisal litigation and return appraisal proceedings to their traditional role as a remedy for oppressed minority stockholders.

The case arose from the 2014 sale of DFC Global Corp., a publicly traded provider of payday loans in the United States, Canada and the United Kingdom. DFC's shares were traded on the Nasdaq exchange with a deep public float and active daily trading volume.

DFC's share price historically moved in reaction to information about the company's performance, the industry and the overall economy.

DFC was highly leveraged with $1.1 billion of debt compared with $367 million of equity market capitalization.

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DEAL HISTORY

In the years leading up to the sale, DFC faced heightened regulatory pressure in all of its primary markets. In the United States, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 created the Consumer Financial Protection Bureau, which was given regulatory, supervisory and enforcement powers over payday lenders.

Sensing the growing regulatory challenges and increased difficulty accessing the public debt market, DFC's board of directors engaged investment bank Houlihan Lokey in spring 2012 to explore selling the company.

Houlihan contacted six private equity sponsors and eventually had discussions with three potential buyers. All three firms eventually lost interest after conducting due diligence.

Over the next year, Houlihan reached out to 35 more financial sponsors and three strategic buyers regarding a potential sale.

In late 2013 DFC unsuccessfully attempted to refinance $600 million in public debt. The company terminated the offering because of insufficient investor interest.

Analysts pointed to the downgrade of DFC's credit rating and market uncertainty regarding the payday lending industry as factors that contributed to cancellation of the debt offering.

DFC renewed discussions with two private equity funds about selling the company. During negotiations, it provided downwardly revised financial projections, suggesting further deterioration of the business.

The company was eventually sold in June 2014 to private equity firm Lone Star Funds for $9.50 per share.

In the Chancery Court, the arbitrage investors seeking appraisal relied on a valuation expert who testified the fair value of DFC was $17.90 per share, which was 88 percent above the deal price based on a discounted cash flow model.

The stockholders' expert also calculated fair value based on a comparable companies analysis using seven peer companies. He then calculated EBITDA multiples using the 75th percentile of the peer group, even though DFC ranked below the 50th percentile in a majority of the key metrics.

This approach yielded equity values for DFC ranging from $11.38 per share to $26.95 per share. If the expert had used the 50th percentile, that is, the median, from his own comparable sample, his calculation would have yielded equity values ranging from roughly $3 to $13 per share, putting the majority of his observations below the deal price.

DUELING VALUATION EXPERTS

In contrast, DFC's expert used both a discounted cash flow model, which valued DFC at $7.81 per share, and a comparable companies analysis, which valued it at $8.07 per share.

He weighted each method equally and so came to a fair value of $7.94, although he also argued the $9.50 per share deal price was a reliable indication of fair value.

The Chancery Court noted the "sharp divide" between the experts' estimates of fair value driven in large part by disagreements about the proper inputs and methods for the discounted cash flow model.

Therefore, the court spent much of its post-trial opinion resolving technical disputes over inputs and assumptions for the discounted cash flow model.

The Chancery Court constructed its own discounted cash flow model, which indicated a fair value of $13.07 per share.

It also evaluated the comparable companies analysis and determined that the value was $8.07 per share.

DOUBTS ABOUT THE DEAL PRICE

Finally, the Chancery Court considered the relevance of the deal price. It recognized that "the merger price in an arm's-length transaction that was subjected to a robust market check is a strong indication of fair value."

It also found that "DFC was purchased by a third-party buyer in an arm's-length sale. The sale process leading

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to the transaction lasted approximately two years and involved DFC's advisor reaching out to dozens of financial sponsors as well as several strategic buyers. The deal did not involve the potential conflicts of interest inherent in a management buyout and negotiations to retain existing management."

However, the Chancery Court also observed that "the market price is informative of fair value only when it is the product of not only a fair process, but also of a well-functioning market."

It concluded that DFC faced an uncertain regulatory environment that created considerable uncertainty about its future profitability and even survival.

The Chancery Court also found that the ultimate purchaser's status as a financial sponsor focused its attention on achieving a certain internal rate of return and on reaching a deal within its financing constraints, rather than on DFC's fair value.

Having expressed doubts about each fair value input, the Chancery Court eventually adopted a "split the difference" approach and used the average of the three methods.

THE HIGH COURT'S REVIEW

Chief Justice Strine began his review of the Chancery Court's decision by focusing on the request that the Delaware Supreme Court create a judicial presumption that the deal price is the best evidence of fair value when the transaction giving rise to appraisal results from an open market check in an absence of conflict of interest. Chief Justice Strine noted that the Delaware Supreme Court rejected a similar argument in *Golden Telecom*.[7]

Chief Justice Strine emphasized that the key language in Section 262 of the Delaware General Corporation Law says stockholders "shall be entitled to an appraisal by the Court of Chancery of the fair value of the stockholder's shares of stock under the circumstances described" elsewhere in the section.

The statute elaborates by instructing that "through such proceeding the court shall determine the fair value of the shares exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation together with interest, if any, to be paid upon the amount determined to be fair value. In determining such fair value the court shall take into account all relevant factors."

The chief justice focused on Section 262's requirement that the Chancery Court consider "all relevant factors" and said "fair value" entails "the value to the stockholder of the firm as a going concern."

Section 262(h) unambiguously calls upon the Chancery Court to perform an independent evaluation of "fair value" at the time of the transaction. It vests the Chancery Court with significant discretion to consider "all relevant factors" and determine the going-concern value of the underlying company.

Requiring the Chancery Court to defer — conclusively or presumptively — to the merger price, even in the face of a pristine, unchallenged transactional process, would contravene the unambiguous language of the statute and established legal precedent. Accordingly, the Delaware Supreme Court declined to create such a presumption.

However, Chief Justice Strine made it clear that "we have little quibble with the economic argument that the price of a merger that results from a robust market check, against the backdrop of a rich information base and a welcoming environment for potential buyers, is probative of the company's fair value."

STILL THE BEST EVIDENCE

Chief Justice Strine recognized the line of Chancery Court cases finding that deal price is the best evidence of value reflects the results of nonconflicted, open-market checks.[8]

"It is unlikely that a particular party having the same information as other market participants will have a judgment about an asset's value that is likely to be more reliable than the collective judgment of value embodied in a market price," he noted. "This, of course, is not to say that the market price is always right, but that one should have little confidence she can be the special one able to outwit the larger universe of equally avid capitalists with an incentive to reap rewards by buying the asset if it is too cheaply priced."

> If the Chancery Court wishes to weigh other indicators of value in determining fair value, it must explain its weighting in a manner that is grounded in the evidentiary record at trial.

The court recognized that "market 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."

It also rejected the Chancery Court's determination that the deal price was unreliable because visibility regarding DFC's future performance was clouded by an uncertain regulatory environment.

Chief Justice Strine noted that the equity analysts, equity buyers, debt analysts, debt providers and others were in fact attuned to the regulatory risk facing DFC. As a result, he said this risk should be reflected in the market price.

The Delaware Supreme Court also rejected the Chancery Court's finding that the deal price was unreliable because the purchaser, a private equity firm, required a specific rate of return on its transaction with DFC.

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"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, or for that matter, any sizeable investment of its capital," the high court said. "That a buyer focuses on hitting its internal rate of return has no rational connection to whether the price it pays is a result of a competitive process is a fair one."

CONCLUSION

"In keeping with our refusal to establish a 'presumption' in favor of the deal price because of the statute's broad mandate, we also conclude that the Court of Chancery must exercise its considerable discretion while also explaining, with reference to economic facts before it and corporate finance principles, why it is according a certain weight to a certain indicator of value," the high court said.

"In some cases, 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," the court added. "In other cases, it may be necessary to consider two or more factors."

Notwithstanding the Delaware Supreme Court's reference to the Chancery Court's discretion and its refusal to establish a formal presumption in favor of the deal price, the high court reversed the Chancery Court's valuation as not being rationally supported by the record. It remanded the case for the Chancery Court to reassess fair value.

The implicit message appears to be that the deal price in a transaction subject to a robust market check and free from conflict of interest is the best evidence of value.

Reading between the lines, the market is more accurate than an individual expert witness. Therefore, the deal price alone should be used to determine fair value unless the Chancery Court finds specific, credible evidence that the sale process was flawed, tainted or otherwise unreliable.

If the Chancery Court wishes to weigh other indicators of value in determining fair value, it must explain its weighting in a manner that is grounded in the evidentiary record at trial.

NOTES

[1] *DFC Global Corp. v. Muirfield Value Partners LP*, No. 518, 2016, 2017 WL 3261190 (Del. Aug. 1, 2017).

[2] 8 Del. C. 1953, § 262(h).

[3] *See Weinberger v. UOP Inc.,* 457 A.2d 701, 712-13 (Del. 1983); *Owen v. Cannon,* No. 8860-CB, 2015 WL 3819204 (Del. Ch. June 17, 2015).

[4] Wei Jiang et al., Appraisal: Shareholder Remedy or Litigation Arbitrage?, 59 J. L. & Econ. 697 (2016).

[5] *In re PetSmart Inc.,* No. 10782-VCS, 2017 WL 2303599 (Del. Ch. May 26, 2017); *Merion Capital LP v. BMC Software Inc.,* No. 8900-VCG, 2015 WL 6164771 (Del. Ch. Oct. 21, 2015); *LongPath Capital LLC v. Ramtron Int'l Corp.,* No. 8094-VCP, 2015 WL 4540443 (Del. Ch. June 30, 2015); *Merlin Partners LP v. AutoInfo Inc.,* No. 8509-VCN, 2015 WL 2069417 (Del. Ch. Apr. 30, 2015).

[6] *In re Appraisal of DFC Global,* No. 10107-CB, 2016 WL 3753123 (Del. Ch. July 8, 2016), *rev'd by DFC Global,* 2017 WL 3261190; *In re Appraisal of Dell Inc.,* No. 9322-VCL, 2016 WL 3186538 (Del. Ch. May 31, 2016); *Owen*, 2015 WL 3819204.

[7] *Golden Telecom Inc. v. Global GT LP,* 11 A.3d 214, 217 (Del. 2010).

[8] *See, e.g., In re PetSmart,* 2017 WL 2303599 at *227-*31; *Merion Capital,* 2015 WL 6164771; *LongPath,* 2015 WL 4540443 at *25-*26; *Merlin Partners,* 2015 WL 2069417; *In re Appraisal of Ancestry.com Inc.,* No. 8173-VCG, 2015 WL 399726 (Del. Ch. Jan. 30, 2015).

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