No Payday for Objecting Stockholders as Delaware Supreme Court Reverses Appraisal Ruling

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The Delaware Supreme Court recently reversed a Delaware Chancery Court's finding that a private equity buyer had underpaid in connection with its acquisition of payday lending firm DFC Global Corporation.

Finding that, following a robust sale process, "economic principles suggest that the best evidence of fair value was the deal price," the Supreme Court rejected the Chancery Court's determination that the deal value was unreliable due to regulatory uncertainty affecting DFC Global and the fact that the prevailing buyer was a financial buyer. The Supreme Court's ruling reflects that in an appraisal proceeding, the deal price in an arms-length transaction will be accorded significant weight regardless of whether the corporation is acquired by a strategic or private equity buyer.

Background

DFC Global provides alternative consumer financial services, primarily payday loans. In 2014, DFC Global was taken private by a private equity sponsor. In connection with that transaction, certain former DFC Global stockholders exercised appraisal rights and sought the Chancery Court to determine the fair value of their shares.

In its July 2016 decision, the Chancery Court considered the relevance of the $9.50 per share deal price that was paid in the 2014 transaction in assessing the fair value of the DFC shares. Recognizing that "[t]he merger price in an arm's-length transaction that was subjected to a robust market check is a strong indication of fair value," the Chancery Court observed that DFC was purchased by a third-party buyer in an arm's-length transaction and that the sale process had lasted approximately two years and involved dozens of financial sponsors as well as several potential strategic buyers. Notwithstanding this "robust" market check, the Chancery Court concluded that the deal price should not be given more than one-third weight in calculating fair value. In particular, the Chancery Court discounted the reliability of the deal price as an indicator of fair value for two reasons. First, DFC Global's performance appeared to be in a trough, "with future performance depending on the outcome of regulatory decision making." Second, the Chancery Court concluded that the buyer'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 Global's fair value." The Chancery Court ultimately gave equal weight to each of a discounted cash flow valuation, a multiples-based valuation and the deal price and concluded that the fair value of DFC Global was $10.21 per share.

The Supreme Court's Decision

On appeal, DFC argued, among other things, that the Delaware Supreme Court should reverse the Chancery Court and establish a presumption that the deal price is the best evidence of fair value when the transaction giving rise to appraisal rights results from an open market check and when certain other conditions pertain. DFC further argued that the reasons given by the Court of Chancery for not giving full weight to the deal price—that DFC faced increasing regulatory constraints that could not be priced by equity market participants and the fact that the prevailing buyer was a private equity rather than a strategic buyer—were not supported by the evidentiary record.

As an initial matter, the Supreme Court declined to adopt a judicial presumption that the deal price in arms-length transactions is the best evidence of fair value. First, the Court noted that the statutory language of DGCL Section 262 required the Court to “take into account all relevant factors” in assessing fair value. Accordingly, the Supreme Court found that the statutory language of Section 262 does not invite the imposition of a presumption and that “[i]f the General Assembly determines that a presumption of the kind sought is in order, it has proven its attentiveness to our appraisal statute and is free to create one itself.” The Supreme Court further observed that there was little need to adopt such a presumption “given the proven record of our Court of Chancery in exercising discretion to give the deal price predominant, and indeed exclusive weight, when it determines, based on the precise facts before it that led to the transaction, that the deal price is the most reliable evidence of fair value.”

Although the Supreme Court declined to adopt the presumption that the deal price is the best evidence of fair value, it reversed and remanded the Chancery Court’s decision observing that there are circumstances where “real world transaction prices can be the most probative evidence of fair value even through appraisal’s particular lens.” The Supreme Court noted that DFC Global’s stock price had often moved as a result of potential regulation of the payday lending industry and that the Chancery Court did not cite any basis to conclude that market participants failed to account for regulatory risk in their assessments of DFC Global’s value. Accordingly, the Supreme Court concluded that the Chancery Court erred in finding that the deal price failed to adequately account for regulatory risk in DFC’s pricing. Critically, the Supreme Court also rejected the Chancery Court’s decision not to give dispositive weight to the deal price because the prevailing bidder was a financial buyer. In the Supreme Court’s view, all rational purchasers, both strategic and financial, should have a targeted rate of return that justifies the risks associated with acquiring a business. According to the Supreme Court, “[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.” The Supreme Court concluded that the evidentiary record could not sustain “the Chancellor’s decision to give only one-third weight to the deal price” and remanded the case, instructing the Chancellor to reassess the weight afforded to various factors potentially relevant to fair value.

Conclusion

The Supreme Court’s decision confirms the importance of the deal price as an indicator of fair value in appraisal proceedings, especially in connection with transactions resulting from a robust sale process. In addition, targets in highly regulated industries should not be subjected to increased appraisal risk, as regulatory uncertainty will generally not limit the significance of deal price in determining fair value. Finally, private equity buyers should find comfort that their transactions will not be targeted for appraisal challenges, as the deal prices in such transactions will generally be accorded the same weight as transactions involving strategic buyers.

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