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IN THE SUPREME COURT OF THE STATE OF DELAWARE

DFC GLOBAL CORPORATION, Respondent-Below, Appellant/Cross-Appellee, v. MUIRFIELD VALUE PARTNERS, L.P., OASIS INVESTMENTS II MASTER FUND LTD., CANDLEWOOD SPECIAL SITUATIONS MASTER FUND, LTD., CWD OC 522 MASTER FUND LTD., and RANDOLPH WATKINS SLIFKA, Petitioners-Below, Appellees/Cross-Appellants.	No. 518, 2016 On Appeal from the Court of Chancery of the State of Delaware, Consolidated C.A. No. 10107-CB

APPELLANT'S OPENING BRIEF

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NATURE OF THE PROCEEDINGS

In this appraisal action, the Court of Chancery correctly found that Appellant DFC Global Corporation ("DFC") was purchased in "an arm's-length sale," resulting from a "robust" process that "lasted approximately two years and involved … reaching out to dozens of [potential buyers]" and "did not involve … conflicts of interest." Ex. A ("Op.") at 59, 62. Nonetheless, the court concluded that DFC's "fair value" exceeded the transaction price. These holdings are incongruous and irreconcilable. This Court should hold that the Court of Chancery committed legal error by not deferring to the arm's-length, conflict-free transaction price.

This case is the perfect illustration of the arbitrariness and imprecision of valuing a company using a speculative, malleable cash-flow model instead of the value proven by a real-world, arm's-length, conflict-free transaction. The Court of Chancery undertook an admirable effort to reconcile the widely divergent views of each side's experts, as is often the case in appraisal actions. The court issued a 65-page opinion laying out a 37-page discounted cash flow analysis that pegged DFC's "fair value" at $13.07 per share, or *38% higher* than the highest price any bidder had been willing to pay for DFC. As part of that analysis, the court's opinion included a thorough and well-reasoned defense of a 3.1% perpetuity growth rate, which the court selected for its model.

After the court issued its opinion, however, DFC realized (and petitioners conceded) that the discounted cash flow calculation attached to the trial court's opinion included working capital figures that differed from the figures the court had expressly adopted in its opinion. Correcting for this one clerical error, the court's discounted cash flow model would have valued DFC at $7.70 per share, or *19% below* the deal price. DFC therefore filed a motion for reargument.

But rather than simply correct this undisputed input error and accept the quantitative result of its own analysis, the court *also* decided to change the perpetuity growth rate from 3.1% to 4.0%, resulting in a new discounted cash flow valuation of $13.33 per share—*40% higher* than DFC's real-world deal price, and back in line with the court's original valuation. No evidence at trial supported a 4.0% perpetuity growth rate. In fact, petitioners argued at trial *in favor of* the 3.1% growth rate the court originally selected, and their expert conceded at trial that the growth rate should not exceed 3.5%. The Court of Chancery's revision requires payment of millions of dollars more than the agreed-upon transaction price.

This episode undermines confidence in Delaware appraisal actions—a longstanding and worsening problem. Prominent economists, legal scholars, and a former Chancellor have implored this Court to refocus the appraisal inquiry on actual transaction prices, because the alternative methods currently used by courts are speculative, manipulable, and unpredictable—and therefore inimical to the

certainty and regularity that corporate transactions require. Moreover, by placing insufficient weight on transaction prices, Delaware courts have created a cottage industry for arbitrageurs, generated significant uncertainty for merger partners, caused a spike in appraisal litigation, and needlessly increased the cost of mergers. In cases such as this one, where a competitive bidding process produces an arm's-length, conflict-free merger, there is no justification for a court not to defer to the actual price paid for the company.

Moreover, the deference that this Court typically gives to the Court of Chancery in appraising the fair value of companies is based on a presumption that the court engages in a thorough and reasoned analysis based on the evidence offered at trial. No such deference is warranted with respect to the court's order on reargument. Although the court did engage in a thoughtful and detailed analysis in generating its original opinion, it subsequently abandoned that analysis on reargument and adjusted its model without proper justification. The court's substantial adjustment to the perpetuity growth rate used in its model was not based on evidence or arguments adduced at trial, and it violates fundamental economic principles and due process.

This Court should reverse and instruct the Court of Chancery either (1) to find that the transaction price represents the "fair value" of DFC shares, or (2) to

return to its original "fair value" determination but correct the undisputed, inadvertent error in its original discounted cash flow analysis.

SUMMARY OF ARGUMENT

1. The Court of Chancery found that DFC was purchased in an arm's-length transaction by the highest bidder after a robust, competitive auction process. DFC's sales price was thus the most reliable measure of its "fair value," and the court erred by not deferring to it. The Court of Chancery's discounted cash flow model was necessarily less reliable, and proved to be so when the court arbitrarily adjusted a key input following the issuance of its original opinion to change the discounted cash flow value. Where, as here, the record demonstrates exactly what willing, disinterested buyers will pay for a company in an arm's-length sale, this Court should hold that it constitutes legal error to deviate from the transaction price.

The court's primary reason for giving little weight to the transaction price—that DFC was sold at a time of regulatory and cash-flow uncertainty—is illogical and has it backwards. Enterprise-threatening uncertainty means that *other* valuation techniques, particularly those that require dependable projections of future cash flows, are necessarily less reliable measures of value. In times of great turmoil, where a company's very existence is in doubt, a robust auction is by far the best means of producing a reliable estimate of that company's going-concern value. Other Court of Chancery decisions have recognized this principle, and the trial court's decision to give the deal price such little weight here cannot stand.

2. At a minimum, the Court of Chancery's arbitrary adjustment to the perpetuity growth rate in its discounted cash flow model on reargument requires reversal. The court delivered a thorough, well-reasoned defense of a 3.1% perpetuity growth rate in its initial opinion. No evidence or arguments adduced at trial, nor anything in the reargument briefing, supported a perpetuity growth rate of 4.0%. The trial court's stated justification—that the near-term working capital corrections the court made implied a higher long-term growth rate—contradicts fundamental economic principles, in part because adjustments in *near-term* working capital needs have no effect on the company's growth rate *in perpetuity*. Indeed, petitioners had embraced at trial a 3.1% perpetuity growth rate, with the same near-term working capital assumptions the court adopted.

The fact that the perpetuity-growth-rate adjustment had the effect of returning the "fair value" determination to roughly the same level as before the court corrected its mathematical error demonstrates the arbitrariness and manipulability of discounted cash flow models. Because the court's adjustment to the perpetuity growth rate contradicts its own, well-reasoned factual findings, it deserves no deference on appeal and should be reversed.

STATEMENT OF FACTS

A. DFC Faces Regulatory and Business Uncertainty

DFC is a Delaware corporation headquartered in Pennsylvania. DFC's business focuses on alternative consumer financial services, colloquially known as payday lending. DFC was publicly traded on the NASDAQ from 2005 until it was acquired by an indirect subsidiary of Lone Star in a merger transaction (the "Transaction"). *See* A88, A95–96.

As of mid-2013, DFC was operating its payday lending business in 10 countries through more than 1,500 retail storefront locations and Internet platforms. Op. at 3. As the Court of Chancery found, DFC faced "significant competition" in each of the countries in which it operated. *Id.* DFC also was subject to regulations from different regulatory authorities across its markets. *Id.* The court found that "[o]ne of the key risks DFC faced was the potential for changes to those regulations that could increase the cost of doing business or otherwise limit the company's opportunities." *Id.* (citing A370–72).

In the United States, for instance, the Consumer Financial Protection Bureau began to supervise and regulate DFC. Op. at 4. As the Court of Chancery found, DFC "was unable to predict whether and to what extent the Consumer Financial Protection Bureau would impose new rules and regulations on it, which had the

potential to adversely affect DFC's business in the United States." *Id.* (citing A372).

In DFC's largest market, the United Kingdom, the Court of Chancery found that "DFC faced an even greater amount of regulatory uncertainty," as a new regulator, the Financial Conduct Authority (the "FCA"), prepared to take over regulation of the payday lending industry on April 1, 2014. Op. at 4 (citing A523); *see also* Op. at 8 n.29. In February 2012, the FCA's predecessor (the Office of Fair Trading, or "OFT") had begun an in-depth review of some of the largest firms in the payday lending business to assess compliance with the Consumer Credit Act and the OFT's lending guidance. Op. at 4 (citing A99). In November 2012, the OFT issued debt collection guidance requiring payday lenders to make certain disclosures to consumers and to avoid using certain debt collection techniques. Op. at 5 (citing A101, A153, A252–53, A535).

In March and April 2013, the OFT sent letters to each of DFC's U.K. businesses identifying deficiencies in their businesses and requiring corrective actions. Op. at 5 (citing A102). The Court of Chancery found that "[t]his regulatory environment imposed certain transitional difficulties on DFC." Op. at 5. As part of an earnings release on April 1, 2013, DFC cut earnings guidance for the fiscal year (ending June 30) from $2.35–$2.45 per share to $1.70–$1.80 per share, noting that the transition period was causing liquidity problems for

consumers in the United Kingdom, resulting in heightened loan default rates. *Id.* (citing A102).

In August 2013, DFC provided fiscal year 2014 adjusted EBITDA guidance of $200–240 million, noting that it was providing adjusted EBITDA rather than earnings per share guidance until DFC had "'clearer visibility as to the amount and timing of these [regulatory] issues.'" Op. at 5 (quoting A362). DFC announced that it expected to operate "'at a continuing competitive disadvantage in the United Kingdom until all industry providers are required to operate consistently under the new regulatory framework.'" Op. at 5–6 (quoting A104–05). The company also stated that it was hopeful its market share would increase as some lenders began to face difficulties operating within the stricter regulatory environment and exited the market. *Id.* (citing A104–05).

In October 2013, the FCA proposed new regulations that DFC expected would be implemented on April 1, 2014, when the FCA assumed its regulatory authority. Op. at 6 (citing A106). As the Court of Chancery found, these proposals included stricter affordability assessments that would be effective April 1, 2014, and other limits (such as two rollovers per loan) that would be effective July 1, 2014. *Id.* Rollovers allow a borrower to defer repayment of a loan by paying additional interest and fees. *Id.* (citing A739, A792). Before the FCA issued its proposals, DFC allowed unlimited and up to six rollovers in its

U.K. retail and Internet businesses, respectively. A739. On November 25, 2013, DFC also received notice that by the beginning of 2015, the United Kingdom would implement a total cost of credit cap (i.e., a rate cap) for the company's products. Op. at 6–7.

On January 30, 2014, DFC cut its adjusted EBITDA projections again, lowering its fiscal year 2014 forecast from $200–240 million to $170–200 million, noting the continued difficulties with the U.K. regulatory transition. Op. at 7 (citing A112).

In February 2014, the OFT sent DFC a letter expressing, as the Court of Chancery found, "serious concerns regarding DFC's ability to meet the FCA's impending new regulations." Op. at 7 (citing A115). The letter threatened that, if DFC did not address the OFT's compliance concerns, it risked not receiving a temporary operating license when the FCA assumed regulatory authority on April 1, 2014. A427; *see also* A159, A256. In response, DFC implemented sweeping changes to its U.K. consumer lending business, including a two-rollover limit effective in late March 2014, and clarified the enhancements to the company's affordability assessments in April 2014. Op. at 7 (citing A115).

DFC believed it had a good track record for navigating regulatory change, giving it a potential advantage over its competitors, and that it might be able to grow where others could not. Op. at 7 (citing A134). DFC had previously

navigated a period of significant regulatory change in Canada from about 2007 to 2010. *Id.* (citing A183–84, A449, A453). The Court of Chancery found that such regulation ended up benefiting DFC as more aggressive competitors were forced to scale back their operations, giving DFC a stronger market position after the regulatory environment stabilized. Op. at 8 (citing A183–84, A737).

Encouraged by its previous success in the Canadian regulatory overhaul, DFC hoped to have a similar experience with the changing U.K. environment. Op. at 8. DFC management thought that some competitors might exit the market in light of the new regulatory regime, allowing DFC to capture additional market share. *Id.* (citing A252, A267–68, A396). However, as the Court of Chancery found, "[t]he competitor exits [DFC] hoped for did not materialize." Op. at 8 n.27 (citing A258–59, A261). Moreover, modifying DFC's U.K. lending practices to accommodate the impending regulations put it at a disadvantage compared to competitors who did not adopt the new regulations before they took effect. Op. at 8 (citing A102). In contrast, some of the key Canadian regulations had little impact on DFC's business because they were rate-focused, and DFC's products in that market already fell within the acceptable rate range. *Id.* (citing A184, A249–50, A278, A736–37).

B. Lone Star Acquires DFC

In April 2012, DFC engaged Houlihan Lokey Capital Inc. ("Houlihan") to investigate selling the company. As the Court of Chancery found, "[t]his decision was inspired in part by the regulatory uncertainty the company faced, in addition to the company's high leverage and questions regarding management succession." Op. at 9 (citing A155).

Houlihan contacted six potential buyers and eventually engaged in discussions with J.C. Flowers & Co. LLC and another potential buyer, as well as an interested third party that Houlihan had not contacted. Op. at 9 (citing A99–100). During the summer, the three potential buyers conducted due diligence. In August 2012, one of the three lost interest in pursuing a transaction. Op. at 9. In October, J.C. Flowers and the other potential buyer also lost interest. *Id.* (citing A100). The Court of Chancery found that "Houlihan spent the next year reaching out to 35 more financial sponsors and three potential strategic buyers." *Id.* (citing A100–01).

In September 2013, DFC renewed discussions with J.C. Flowers and began discussions with Crestview Partners about a possible joint transaction. Op. at 9 (citing A106). In October 2013, Lone Star also expressed potential interest in DFC. Op. at 10 (citing A107).

In November 2013, DFC gave the three potential acquirers financial projections prepared by DFC's management. Op. at 10 (citing A109–10). On December 12, 2013, Crestview announced it was no longer interested in pursuing a transaction. *Id.* (citing A111). However, Lone Star made a preliminary non-binding indication of interest in acquiring DFC for $12.16 per share. *Id.* On December 17, J.C. Flowers made its own non-binding indication at $13.50 per share. *Id.* (citing A111).

On February 14, 2014, DFC's board approved a set of revised projections prepared by management, which it shared with J.C. Flowers and Lone Star. Op. at 10 (citing A113–14). These projections lowered DFC's projected earnings compared to the projections approved in November. *Id.* (citing A109–10, A113). On February 28, 2014, Lone Star offered to buy DFC for $11.00 per share and requested a 45-day exclusivity period. Op. at 10–11 (citing A115). Lone Star explained that the reduction in its offering price was due to the U.K. regulatory changes, the threat of increased U.S. regulatory scrutiny, downward revisions to DFC's projections, reduced availability of acquisition financing, stock price volatility, and the weakness of the Canadian dollar. Op. at 11 (citing A116). J.C. Flowers informed DFC that it was no longer interested in a transaction, concluding that DFC "was a risk not worth taking … because of where the regulatory environment was ultimately headed in the U.K." A158–59; *see also* A642. On

March 11, DFC entered into an exclusivity agreement with Lone Star. Op. at 11 (citing A118).

On March 26, 2014, DFC provided Lone Star with DFC management's revised preliminary adjusted EBITDA forecast for fiscal year 2014, which had dropped by $29.4 million compared to the February projection of $182.5 million. A113, A471, A525–31. The next day, Lone Star made a "best and final" offer to buy DFC for $9.50 per share, explaining that this new reduction in price took into account, among other things, the further downward revisions in DFC's projections, continued regulatory changes in the U.K., and a class action suit against the company that was disclosed in a Form 8-K filed on March 26, 2014. Op. at 11 (citing A119–20).

At the end of March, DFC approved another set of projections (the "March Projections") and directed management to share them with Lone Star. Op. at 12 (citing A122–23). Projected earnings dropped again compared to the February projections. *Id.* (citing A109–10, A113, A123). On April 1, 2014, DFC's board approved the Transaction and entered into a merger agreement with Lone Star. *Id.* (citing A125). The next day, DFC announced the Transaction and publicly cut its earnings outlook once again, reducing its 2014 fiscal year EBITDA projections from $170–200 million to $151–156 million. *Id.* (citing A126).

DFC's performance continued to deteriorate after the merger agreement was signed through the closing on June 13, 2014. Op. at 12 (citing A89); A261, A278–79. Regulatory restrictions in the United Kingdom limited DFC's ability to offer its traditional loan products and dramatically reduced loan volumes, causing DFC to miss the already-lowered March Projections. A261, A279. The March Projections forecasted EBITDA of $43.4 million for the last four months of the fiscal year ending June 30, 2014, but DFC missed this forecast by approximately $14.4 million. A473, A569. This downward trend continued in fiscal year 2015. A280. DFC reported revenue of $711.3 million and EBITDA of $45.5 million for the fiscal year ending June 30, 2015, below the March Projections by 34% and 75%, respectively. *Compare* A1195 and A1206, *with* A123 and A475.

C. Procedural History

Between June 18 and October 1, 2014, petitioners filed petitions for appraisal under 8 *Del. C.* § 262. Op. at 13. The Court of Chancery held a three-day trial in October 2015. *Id.*

On July 8, 2016, the court issued a 65-page Memorandum Opinion. The court found that Lone Star purchased DFC in "an arm's-length sale," resulting from a "robust" process that "lasted approximately two years and involved … reaching out to dozens of [potential buyers]" and "did not involve … conflicts of interest." Op. at 59, 62. The court held that these circumstances provide "a

reasonable level of confidence that the deal price can fairly be used as one measure of DFC's value." Op. at 59. Nonetheless, the court gave the deal price ($9.50 per share) only one-third weight in its fair-value assessment, reasoning that because the transaction occurred during a period of regulatory uncertainty and what might turn out to be "DFC's trough performance," the deal price "would not necessarily be a reliable indicator of DFC's intrinsic value." Op. at 62.

The court also gave one-third weight each to a discounted cash flow model and a multiples-based comparable companies analysis. Op. at 59–65. The court made numerous determinations and findings in the course of constructing its discounted cash flow model. Significantly, the court adopted the five-year working capital assumptions from DFC's March Projections. To value DFC's future cash flows beyond the five-year projection period, the court adopted a two-stage discounted cash flow model and selected 3.1% as the second-stage growth rate (i.e., the growth rate that would extend into perpetuity, also known as the terminal growth rate). Op. at 44–52. The court's opinion stated that its discounted cash flow model generated a value of $13.07 per share. Op. at 54–55.

The Court of Chancery's multiples-based comparable companies analysis produced a value for DFC of $8.07 per share. Op. at 56. The court averaged the outputs of the three valuations methodologies and concluded that DFC's "fair value" was $10.21 per share. Op. at 65.

DFC filed a motion for reargument, explaining that, although the court had decided to use the March Projections' working capital assumptions, the summary of the Court's discounted cash flow analysis in Appendix A to the opinion inadvertently used different figures that the court had expressly rejected in the text of the opinion. A1330–31. Correcting this one error lowered the court's discounted cash flow valuation to $7.70 per share, which, when averaged with the outputs of the two other valuation methodologies, produced a corrected "fair value" for DFC of $8.42 per share, more than $1 per share *less* than the sales price. A1334–35.

Petitioners' response to DFC's motion for reargument did not dispute that the Court of Chancery's working capital assumptions were erroneous and required correction. A1341. However, petitioners argued for the first time that the court should also change the perpetuity growth rate assumption to 4.0%, even though their own expert had advanced the 3.1% growth rate, and no evidence had been adduced at trial to support a 4.0% perpetuity growth rate. A1347. Petitioners explained that raising the perpetuity growth rate to 4.0% would generate a discounted cash flow valuation of $13.33 per share, back in line with the court's original calculation. *Id.*

The court adopted petitioners' new argument, corrected its working capital assumptions, and raised the perpetuity growth rate to 4.0%. Ex. B at 6. The court

adjusted its discounted cash flow valuation to $13.33 per share, and, after re-averaging the three valuation methodologies, concluded that DFC's "fair value" was $10.30 per share—$0.09 higher than the valuation in its original opinion. *Id.* at 7.

DFC timely noticed this appeal.

ARGUMENT

I. WHERE, AS HERE, A ROBUST, COMPETITIVE BIDDING PROCESS RESULTS IN AN ARM'S-LENGTH SALE TO A DISINTERESTED BUYER, THE TRANSACTION PRICE REFLECTS THE COMPANY'S "FAIR VALUE."

A. Question Presented.

Whether Section 262 of the Delaware General Corporation Law and fundamental due process required the Court of Chancery to find that DFC's "fair value" was its actual sale price, given that DFC was sold in an arm's-length, conflict-free transaction to the highest bidder after a robust, competitive bidding process. *See* A54–58, A1271–72.

B. Scope of Review.

"The interpretation and application of the mandates in Section 262 to [an] appraisal proceeding presents a question of law. Therefore, the Court of Chancery's construction of Section 262 must be reviewed *de novo* on appeal." *M.G. Bancorporation, Inc. v. Le Beau*, 737 A.2d 513, 524 (Del. 1999). The Court of Chancery errs "as a matter of law" by relying on improper "criterion for determining the fair value" of an enterprise. *Paskill Corp. v. Alcoma Corp.*, 747 A.2d 549, 554 (Del. 2000).

C. Merits of Argument.

In an appraisal action, the Court of Chancery "shall determine the fair value of the shares" owned by dissenting stockholders. 8 *Del. C.* § 262(h). Where, as

here, a robust bidding process produces an arm's-length, conflict-free sale to a disinterested buyer, the most reliable measure of the company's "fair value" is the transaction price. That principle is axiomatic among economists and finance professionals, and should be required as a matter of law. In many cases, the Court of Chancery has deferred to the deal price after a competitive and conflict-free bidding process. But the court below did not, using instead a speculative discounted cash flow analysis that produced a "fair value" far higher than what any buyer was willing to pay for DFC, creating a windfall for the dissenting stockholders. Decisions like the one below are generating significant uncertainty for transacting parties across the nation, increasing the frequency and scale of appraisal litigation in this State, creating a cottage industry for arbitrageurs, and needlessly increasing the cost of mergers. This Court should resolve this longstanding and recurring problem and hold that Section 262 precludes courts from using *necessarily* less reliable discounted cash flow analyses when the *most* reliable measure of value—an arm's-length and conflict-free sale to a disinterested buyer following a robust auction process—is available.

1. "Everything is worth what its purchaser will pay for it." Publilius (1st Century B.C.) (quoted in Glenn M. Desmond & Richard E. Kelley, *Business Valuation Handbook* 1 (1988)); *see also* William J. Carney, *Fairness Opinions: How Fair Are They and Why We Should Do Nothing About It*, 70 WASH. U. L.Q.

523, 527 (1992) ("A good is only worth what a willing buyer will pay for it—no more, no less."). Where, as here, it is *known* what willing and disinterested buyers will pay for a company, there is no more reliable measure of the company's "fair value."

The Court of Chancery generally recognizes this principle, and has deferred 100% to the sales price when it is the product of an arm's-length, competitive bidding process. In *The Union Illinois 1995 Investment Limited Partnership v. Union Financial Group, Ltd.*, 847 A.2d 340 (Del. Ch. 2004), for example, then-Vice Chancellor Strine deferred to the arm's-length sales price in a Section 262 appraisal action, explaining that, "[f]or me (as a law-trained judge) to second-guess the price that resulted from that [arm's-length] process involves an exercise in hubris and, at best, reasoned guess-work." *Id.* at 359.

Similarly, in *Huff Fund Investment Partnership v. CKx, Inc.*, 2013 WL 5878807, at *13 (Del. Ch. Nov. 1, 2013), *aff'd*, 2015 WL 631586 (Del. Feb. 12, 2015), the court gave full weight to a competitively bid sales price. Vice Chancellor Glasscock analogized the merger to the sale of a piece of real property, explaining that, "if the sale were an arms-length, disinterested transaction after an adequate market canvas[s] and auction," "[i]t would be odd" for someone to say "that the price received did not represent 'fair' value." *Id.* at *1. Indeed, appraisals "relying on speculative future income from the property" would be

nothing more than "educated guesses … as to what price could be achieved by exposing the property to the market." *Id.*

Numerous other decisions have followed this same logic and deferred entirely to the arm's-length sales price. *See, e.g.*, *Merion Capital LP v. BMC Software, Inc.*, 2015 WL 6164771, at *14–16, *18 (Del. Ch. Oct. 21, 2015) (merger price was "best indicator of fair value" where company "conducted a robust, arm's-length sale process"); *LongPath Capital, LLC v. Ramtron Int'l Corp.*, 2015 WL 4540443, at *20–24 (Del. Ch. June 30, 2015) (merger price was "best indication of fair value" where transaction resulted from a "lengthy, publicized process" during which company "actively shopped itself to other conceivable buyers, several of which indicated serious interest"); *Merlin Partners LP v. AutoInfo, Inc.*, 2015 WL 2069417, at *11–14, *16 (Del. Ch. Apr. 30, 2015) (giving full weight to merger price where transaction "was negotiated at arm's length, without compulsion, and with adequate information"); *In re Appraisal of Ancestry.com*, 2015 WL 399726, at *16, *23–24 (Del. Ch. Jan. 30, 2015) (merger price was "best indicator … of fair value" where "sales process was reasonable, wide-ranging and produced a motivated buyer"); *see also In re Rural Metro Corp. S'holders Litig.*, 88 A.3d 54, 102 (Del. Ch. 2014) ("Ordinarily this court places heavy reliance on the terms of a transaction that was negotiated at arm's length, particularly if the transaction resulted from an effective pre- or post-agreement

market canvas[s]."); *In re Creole Petroleum Corp.*, 1978 WL 2487, at *2 (Del. Ch. Jan. 11, 1978) (noting that market value "is normally worthy of great weight").

Indeed, the Court of Chancery has explained that substantial deviation from the deal price is justifiable *only* if the transaction was tainted in some fashion. *See*, *e.g.*, *In re Appraisal of Dell Inc.*, 2016 WL 3186538, at *23, *42–44 (Del. Ch. May 31, 2016) (holding that arm's-length sales price would normally receive "substantial evidentiary weight" but declining to do so in management buyout where management was found to have significant inside information); *In re Rural Metro Corp.*, 88 A.3d at 102 (describing traditional "heavy reliance" on price paid but noting an exception for cases featuring a "faulty [sales] process").

Nevertheless, the Court of Chancery has too often given short shrift to the sales price and instead deferred to speculative discounted cash flow models. The practice confounds economists and scholars, including a former Chancellor, who have called upon this Court to provide much-needed uniformity and guidance on the probative value of arm's-length sales prices.

Former Chancellor William T. Allen, for example, has written that "this is an area in which corporation law would reach sounder results if it accepts a reasonably efficient market hypothesis, that is a method that gave *heavy presumption* to market prices." William T. Allen, *Securities Markets as Social Products: The Pretty Efficient Capital Market Hypothesis*, 28 J. CORP. L. 551,

560–61 (2003) (emphasis added). According to Chancellor Allen, Delaware courts have "failed to fully appreciate" the "truly speculative nature" of alternative valuation methods, such as discounted cash flow analyses, which are particularly susceptible to "manipulation and guesswork." *Id.*

Professor Daniel R. Fischel has likewise called upon Delaware courts to embrace the "conceptual clarity, simplicity, and objectivity" of market prices, explaining that reliance on alternative valuation techniques when actual market prices are available has led to "one of the most embarrassing episodes in corporate law history." Daniel R. Fischel, *Market Evidence in Corporate Law*, 69 U. CHI. L. REV. 941, 942, 954 (2002). Other leading scholars agree. *See, e.g.*, Barry M. Wertheimer, *The Shareholders' Appraisal Remedy and How Courts Determine Fair Value*, 47 DUKE L.J. 613, 655 (1998) (explaining that "[t]he best evidence of value, if available, is third-party sales value" and that courts should rely on "less precise valuation techniques" only as a last resort; "[d]espite the compelling sensibility of this argument, courts conducting appraisal proceedings have accorded third-party sales value a mixed and confusing reception").

This case vividly illustrates the stark contrast between the "manipulation and guesswork" involved in discounted cash flow analyses and the "conceptual clarity, simplicity, and objectivity" of arm's-length sales prices. Despite having the benefit of a sales price resulting from a robust, competitive bidding process, the

Court of Chancery embarked on a complicated, 37-page discounted cash flow analysis sensitive to numerous financial assumptions (e.g., beta, perpetuity growth rate, tax rate, net working capital), which required choosing sides on several academic debates over the "proper" discounted cash flow methodology (e.g., "raw beta" vs. "smoothed beta," the "Fernandez formula" vs. the "Hamada formula," a "two-stage model" vs. a "three-stage model," and the "Gordon growth model" vs. the "convergence model"). Op. at 17–55. The result was not an accurate determination of the actual value of DFC in June 2014, but instead an exercise in false precision. *See* William J. Carney & Mark Heimendinger, *Appraising the Nonexistent: The Delaware Courts' Struggle with Control Premiums*, 152 U. PA. L. REV. 845, 847 (2003) ("While the Delaware courts appear to believe they are using the science of financial economics in their valuation efforts, their misunderstandings have led to windfalls for dissenting shareholders.").

The significant changes in valuation resulting from minor adjustments to certain variables highlights the arbitrariness of a discounted cash flow model. In this case, the court initially selected a 3.1% perpetuity growth rate in a thorough and well-reasoned order, resulting in a discounted cash flow valuation of $13.07 per share, or 38% *higher* than any company was willing to pay for DFC. When it was discovered that the court had mistakenly used rejected figures for just one of the discounted cash flow inputs (the working capital assumptions), DFC's

valuation instantly dropped to $7.70 per share, or 19% *less* than DFC's sales price. Then, on reargument, the court arbitrarily increased the perpetuity growth rate to 4.0%, resulting in a new discounted cash flow valuation of $13.33 per share, or 40% *higher* than the price DFC fetched in the open market. Thus, DFC's buyer either overpaid *or* underpaid for DFC by *tens or even hundreds of millions of dollars*, depending on which speculative assumptions the court utilized as inputs to its discounted cash flow analysis.

Of course, if DFC was really worth $13.33 per share—as the court's discounted cash flow model suggested—then any rational party would have topped Lone Star's $9.50 bid for an instant, multimillion-dollar windfall. *See S. Muoio & Co. v. Hallmark Entm't Invs. Co.*, 2011 WL 863007, at *18 (Del. Ch. Mar. 9, 2011) ("If Crown was really worth $2.95 billion (as [plaintiffs' expert] claims), the most knowledgeable and sophisticated buyers in the industry would not have readily passed on an opportunity to obtain substantial returns on an investment in Crown."), *aff'd*, 35 A.3d 419 (Del. 2011) (Table).

As this episode illustrates, the discounted cash flow method is too manipulable and dependent on guesswork to be used in the face of an arm's-length sales price, which is consistently simple, reliable, and objective.

2. Why, then, do courts continue to rely on discounted cash flow models when an arm's-length sales price is available? Some courts misinterpret Section

262's directive to "take into account all relevant factors" as *requiring* the use of objectively inferior valuation techniques. But the only "relevant factor" in a case like this one is the price paid by the highest bidder, because alternative valuations are necessarily inferior measures of value.

As then-Vice Chancellor Strine explained in *Union Illinois*, 847 A.2d at 359, the beauty of the open-market bidding process is that the potential buyers have already utilized alternative valuation techniques to craft their bids. And those bidders—unlike the judge, the expert witnesses, and the parties' attorneys—have "a profit motive" to make the best possible cash-flow assumptions "and to use those assessments to make bids *with actual money behind them*." *Id.* (emphasis added). Thus, an arm's-length sales price already encompasses alternative valuation techniques, but performed by the bidding parties who have the highest incentive to "get it right."

Compared with an arm's-length sales price, a judge's "use of alternative valuation techniques like a [discounted cash flow] analysis *is necessarily a second-best method to derive value*." *Union Illinois*, 847 A.2d at 359 (emphasis added); *see also* Wertheimer, 47 DUKE L.J. at 654 ("Anything short of third-party sales value is merely theoretical, or guesswork."). It thus makes no sense to assess fair value by averaging a *more* reliable valuation with a *less* reliable valuation, as the Court of Chancery did here. If asked to "take into account all relevant factors" in

reporting the time of day, no one would average the readings of a digital watch and a sundial; or report the length of a wall by averaging a tape measure reading with the results of someone stepping off the distance heel to toe. Simply put, Section 262 does not permit—let alone require—courts to dilute a reliable fair value assessment by giving weight to necessarily inferior valuation techniques.

This Court's decision in *Golden Telecom, Inc. v. Global GT LP*, 11 A.3d 214 (Del. 2010), is not to the contrary. There, the Court "reject[ed] [a] call to establish a rule requiring the Court of Chancery to defer to the merger price in *any* appraisal proceeding." *Id.* at 218 (emphasis added). DFC is not asking this Court to establish such a sweeping rule; it instead submits that deference to the merger price is appropriate where the transaction involves no insiders and follows a thorough and conflict-free sales process. The merger in *Golden Telecom*, like many transactions, would not meet this high standard—it was not an arm's-length sale to a disinterested party, as the target company's largest stockholders were also the acquiring company's largest stockholders. *Id.* at 215–16. Nor did the Court of Chancery in *Golden Telecom* find that the merger was a product of a robust, competitive bidding process, as the court found in this case. The "unchallenged transactional process" to which this Court alluded in *Golden Telecom* was simply not before the Court. *Id.* at 218.

This case, however, presents the type of arm's-length, disinterested transaction that necessarily produces the most reliable estimate of a company's "fair value." Section 262 does not require a court to use alternative measures of value in such circumstances; to the contrary, this Court should declare that using a necessarily less reliable measure constitutes reversible legal error.

3. The Court of Chancery's stated reasons for not deferring to the transaction price in this case have nothing to do with the auction process or any other procedural improprieties. The court questioned the probative value of the transaction price because: (a) DFC was subject to so much uncertainty that, according to the Court of Chancery, the market may have functioned imperfectly, with only Lone Star able to see a diamond in the rough; and (b) Lone Star is a financial sponsor that was focused, at least to some degree, "on achieving a certain internal rate of return and on reaching a deal within its financing constraints, rather than on DFC's fair value." Op. at 62–63. Neither of these points justifies departing from the transaction price.

The first point—that the sale price supposedly was less reliable because DFC was sold during a period of regulatory uncertainty—has it exactly backwards. The fact that DFC's future was in serious doubt and could go *out of business* in its primary market (the United Kingdom) meant that valuation techniques that require reliable future cash-flow projections were virtually worthless. Only a fair auction

process could generate a reliable valuation, given the great uncertainty surrounding DFC. Dozens of sophisticated potential buyers learned everything there was to know about DFC's financials and the prevailing regulatory climate. That none of them, apart from Lone Star, was ultimately willing to pursue a deal does not signal a breakdown in a normally efficient market. It suggests only that other prospective buyers had decided that the risk-adjusted expected value of DFC as a going concern was not high enough to warrant a bid. Lone Star did not enjoy access to inside information that was unavailable to other potential bidders; it did not "exploit" regulatory or other uncertainty; and it did not win the auction because every other potential buyer was irrationally fearful of a risk that would not materialize. Lone Star won the auction because it was willing to take on a risk, at $9.50 per share, that every other potential buyer had concluded was too high. There was no market failure here—the market worked in its usual manner to reward (or curse) the high bidder with the prize (or millstone).

Indeed, several recent decisions confirm that uncertainty regarding a company's future business prospects is no reason to give less weight to the merger price produced by a rigorous sales process. For example, in *CKx*, the asset representing approximately 60 to 75% of CKx's cash flow, the rights to *American Idol*, had declined in value for five straight years, and its future growth prospects were uncertain. 2013 WL 5878807, at *2–3. The court nonetheless concluded that

the merger price resulting from a thorough, effective, and arm's-length sales process was "the most reliable indicator of value." *Id.* at *13. Similarly, in *Ancestry.com*, the court found that a merger price produced by a "reasonable, wide-ranging" sales process was the "best indicator" of fair value, even though the process was commenced during a period of uncertainty regarding Ancestry.com's market and key growth drivers. *In re Appraisal of Ancestry.com*, 2015 WL 399726, at *3, *16, *24. Likewise, in *Ramtron*, the company "was cash-strapped and struggling from a liquidity standpoint at the time of the Merger," but because the marketing process was thorough and free of conflicts, "the resulting price accordingly provide[d] a reliable indication of Ramtron's fair value." *Ramtron*, 2015 WL 4540443, at *3–6, *20–24. And in *AutoInfo*, the court relied on the sales price alone despite the fact that the company's financials were clouded by several accounting irregularities that required reevaluation of the terms of the deal. 2015 WL 2069417 at *5–6, *14, *18. These courts understood what the court below missed—that great uncertainty about a company's future renders an arm's-length sales price the *more* reliable measure of the company's going-concern value, and that other subjective valuation techniques, particularly those beholden to future cash-flow projections, are the *less* reliable measures.

The Court of Chancery's second reason for departing from the actual price paid—that Lone Star's "investment thesis" was more focused on financing

mechanics than the fair value of the underlying asset—is also illogical. Op. at 62–63. Any buyer runs the risk of losing the prize by underbidding to accommodate its own financing or return constraints. Even if the Court of Chancery was correct that Lone Star was less concerned about DFC's "fair value" (Op. at 63), there was no evidence that the dozens of *other* sophisticated potential buyers approached the transaction the same way. The court's heavy focus on the winning bidder's objectives is puzzling in light of the large field of rational bidders, all of whom were on the lookout for deals and market inefficiencies and all of whom passed up the opportunity to pay more than Lone Star. *See Ramtron*, 2015 WL 4540443, at *24 (Ramtron's "lengthy publicized process was thorough and gives me confidence that, if Ramtron could have commanded a higher value, it would have.").

The decision not to defer to the transaction price in this case is even less defensible given that the court acknowledged the analytical frailties of a discounted cash flow approach. *See* Op. at 61 (noting that the repeated revisions to financial projections undermined the court's confidence in its discounted cash flow analysis). Delaware courts have often expressed suspicion of the discounted cash flow methodology where, as here, the underlying inputs are unreliable. In such cases, the courts sensibly have assigned limited or no weight to discounted cash flow analyses. *See, e.g.*, *AutoInfo*, 2015 WL 2069417, at *8 (financial forecasts

too unreliable to support discounted cash flow analysis); *Ramtron*, 2015 WL 4540443, at *10–18 (same); *see also Highfields Capital, Ltd. v. AXA Fin., Inc.*, 939 A.2d 34, 52–53 (Del. Ch. 2007) (noting that a discounted cash flow approach "has much less utility in cases where the transaction giving rise to appraisal was an arm's-length merger, [or] where the data inputs used in the model are not reliable"). The Court of Chancery nevertheless assigned its discounted cash flow valuation substantial weight—indeed, equal weight as compared to the transaction price. And that decision alone is responsible for the appraisal premium because the discounted cash flow analysis is the only methodology that yielded a valuation higher than the actual price paid.

4. There are also significant policy reasons for deferring to arm's-length sales prices in appraisal actions. The present state of affairs—whereby transacting parties have no idea whether a court will respect the actual price fetched in the open market, even after a robust, competitive bidding process—is unacceptable and undermines the principal cornerstones of Delaware corporate law, namely predictability, certainty, and transparency. *See*, *e.g.*, *Broz v. Cellular Sys., Inc.*, 673 A.2d 148, 159 (Del. 1996) ("[C]ertainty and predictability are values to be promoted in our corporation law."); Keith Sharfman, *Contractual Valuation Mechanisms & Corporate Law*, 2 VA. L. & BUS. REV. 53, 59–62 (2007) (describing significant uncertainty in Delaware appraisal actions, leading to

expensive and hard-to-settle litigation—a "wasteful arms race from which neither society nor the valuation litigants themselves derive any net benefit").

Delaware courts' failure to defer to arm's-length sales prices is needlessly increasing M&A litigation. "Results that depart so dramatically from economic reality"—as in this case, where the court deemed DFC's "fair value" to be higher than any company was willing to pay for it—"encourage litigants to play a lottery by increasing the number of cases involving valuation issues." William J. Carney & George B. Shepherd, *The Mystery of Delaware Law's Continuing Success*, 2009 U. ILL. L. REV. 1, 27–28 (2009). "A misunderstanding of finance or an overemphasis on misguided doctrine can produce results that both depart wildly from market valuations and encourage litigation." *Id.* at 26; *see also* Raluca Papadima et al., *Shareholder Exit Signs on American & European Highways: Under Construction*, 18 U. PA. J. BUS. L. 1059, 1077–78 (2016) (describing "problematic" rise in appraisal litigation which "overloads the dockets of the Delaware judges, who have to spend a significant portion of their time playing investment banker without commensurate compensation"); Christina E. Carroll & Thomas J. Hope, *Appraisals Gone Wild!: Spotlight on Fair Value Appraisal Cases in Delaware*, Stout Risius Ross (Fall 2016) *available at* http://www.srr.com/assets/pdf/appraisals-gone-wildspotlight-fair-value-appraisal-cases-delaware.pdf (noting recent rise in appraisal litigation).

The present "lottery" environment has also spawned a cottage industry of appraisal arbitrageurs. These arbitrageurs constitute "a new and expanding phenomenon of shareholder activists and hedge funds focusing on appraisal claims as a kind of investment in and of themselves." Philip Richter et al., *The Rise of Delaware Appraisal Arbitrage: A Survey of Cases and Some Practical Implications*, Insights: Corp. & Sec. L. Advisor, July 2014, at 18. An appraisal arbitrageur essentially makes a bet that the court will substitute the arm's-length sales price with a more generous, alternative valuation technique, generating a windfall for the arbitrageur. *Id.* at 21 (noting that Delaware appraisal actions produce an average "appraisal premium" of 148.8% *above* the merger price); *see also* Miles Weiss, *Dell Value Dispute Spotlights Rise in Appraisal Arbitrage*, Bloomberg, Oct. 3, 2013 ("Money managers … have developed a strategy known as appraisal arbitrage in which they buy stock in takeover targets after a deal is announced and then seek a higher valuation from the chancery court."). Ultimately, this growing phenomenon is needlessly raising the costs of mergers and acquisitions for Delaware corporations. *See* Papadima et al., *supra*, U. PA. J. BUS. L. at 1078–79 ("The threat of appraisal litigation has started to affect the dynamics surrounding the negotiation of merger transactions, as it can have a significant effect on the price ultimately paid in the transaction, as well as deal-threatening potential by reducing closing certainty"); Nicholas O'Keefe, *Delaware*

Appraisal Actions Are Likely to Continue to Increase in Frequency Following Two Recent Delaware Chancery Court Decisions, Kaye Scholer, Feb. 24, 2015 ("Appraisal arbitrage can be viewed as another deal tax, akin to the deal tax imposed by fiduciary duty strike suits.").

This "increased strategic use and threat of appraisal actions can increase uncertainty and risk both for buyers and sellers," and prevents otherwise economically efficient transactions from occurring. Richter, *supra*, at 22. The solution to this significant problem is simple: where, as here, a robust, competitive bidding process has yielded an arm's-length transaction price, courts should defer to that transaction price as the "fair value" in appraisal actions.

Deferring to the transaction price in conflict-free, arm's-length mergers also furthers the primary objectives of appraisal. The modern appraisal remedy "serves a minority shareholder protection role," protecting minority stockholders from self-dealing and conflicted transactions. *Wertheimer*, 47 DUKE L.J. at 615–16; *see also* Ronald J. Gilson & Bernard S. Black, *The Law and Finance of Corporate Acquisitions* 718–22 (2d ed. 1995) (explaining that the role of appraisal rights is to provide managers with *ex ante* incentives to avoid misconduct); Robert B. Thompson, *The Case for Iterative Statutory Reform: Appraisal and the Model Business Corporation Act*, 74 LAW & CONTEMP. PROBS. 253, 266–67 (2011) (purpose of appraisal is effectuated when it is reserved for transactions involving

conflicts of interest or irregularities that "cast[] doubt on the fairness of the transaction").

In other words, appraisal is designed to protect stockholders in the *absence* of a robust auction leading to a sale to a disinterested buyer. Where, as here, that safeguard was provided, the transaction does not implicate the concerns underlying the appraisal remedy.

II. THE COURT OF CHANCERY ERRED BY ARBITRARILY ALTERING ITS PERPETUITY GROWTH RATE ON REARGUMENT

A. Question Presented.

Whether the Court of Chancery erred by dramatically increasing the perpetuity growth rate on reargument from 3.1% to 4.0%, when none of the evidence or arguments adduced at trial supported a 4.0% growth rate and the court's stated justification for the adjustment violates fundamental economic principles and due process. *See* A1380–82.

B. Scope of Review.

This Court generally reviews the Court of Chancery's fair-value assessment for an abuse of discretion; however, a fatally flawed valuation process requires reversal. *See Gonsalves v. Straight Arrow Publishers, Inc.*, 701 A.2d 357, 360 (Del. 1997).

C. Merits of Argument.

This Court understandably gives a high level of deference to the assumptions the Court of Chancery uses as part of its fair-value assessments, provided the court has engaged in a thorough, independent, and well-reasoned analysis based on the evidence adduced at trial. *See Gonsalves*, 701 A.2d at 360. But where the Court of Chancery's "valuation process was fatally flawed … the matter must be reversed and be remanded for further consideration." *Id.* at 362.

Here, the Court of Chancery's reargument order, which made a significant and unsupported change to the perpetuity growth rate that the court used in its discounted cash flow analysis, was "fatally flawed"; thus, its revised discounted cash flow analysis is not entitled to any deference. It is the court's *original* opinion that demonstrates the type of analysis this Court has said deserves deference—a thorough discussion of the various discounted cash flow considerations, careful selection of assumptions and modeling choices, and detailed explanation for the court's findings.

If the Court of Chancery had stuck with its original analysis and simply corrected the one undisputed clerical error in its model to conform with its detailed analysis, its analysis might be worthy of deference. Instead, the court corrected the working capital error but also made a significant and unsupported change to the perpetuity growth rate, which had the effect of bringing the court's valuation conclusion back in line with its original opinion. The Court of Chancery's adjustment in the perpetuity growth rate from 3.1% to 4.0% contradicted the findings in its original opinion, was not supported by any evidence or arguments adduced at trial, and violates fundamental economic principles and due process.

1. As a threshold matter, it is hard to overstate the significance of a change from 3.1% to 4.0% in a perpetuity growth rate. The perpetuity growth rate is the annual rate at which the company is expected to grow *forever*. Because

perpetuity growth rates are exponential and extend in perpetuity, small changes have enormous effects on the company's value.[1]

Indeed, a change from 3.1% to 4.0% spans nearly the entire range of acceptable perpetuity growth rates. *See* Seller et al., *supra*, note 1, at 10 (noting studies that place the "average long-term terminal growth" rate at 3.2% and an acceptable range for mature companies of "3 to 4 percent"); Bradford Cornell, *Economic Growth and Equity Investing*, Vol. 66 No. 1 FIN. ANALYSTS 54, 61 (Jan./Feb. 2010) ("current investors should count on long-run growth in real earnings of no more than 1 percent" above inflation). A perpetuity growth rate's "floor" is typically the forecasted rate of inflation in the company's relevant market (here, 2.0% in both the U.K., DFC's primary market, and Canada, DFC's second-largest market), and its "ceiling" cannot exceed the nominal GDP growth rate (here, 4.4% in the U.K. and 4.1% in Canada). *See* International Monetary Fund, *World Economic Outlook Database April 2014*, *available at*

[1] *See*, *e.g.*, Keith F. Seller et al., *Quantifying Terminal Growth Rates: Some Empirical Evidence*, The Value Examiner 8, Nov./Dec. 2013 ("Any experienced valuation analyst is aware that terminal value calculations typically account for more than half of the final value determined with a discounted cash flow model."); Shannon P. Pratt, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies* 243 (5th ed. 2008) ("Changes in the growth rate projected, sometimes seemingly small, can result in striking changes."); James R. Hitchner, *Financial Valuation: Application and Models* 1252 (3d ed. 2011) ("The selection of the sustainable long-term average growth rate can have a large effect on the value conclusion.").

http://www.imf.org/external/ pubs/ft/weo/2014/01/weodata/index.aspx; *see also Towerview LLC v. Cox Radio, Inc.*, 2013 WL 3316186, at *26–27 (Del. Ch. June 28, 2013). Companies with 3.1% and 4.0% perpetuity growth rates are often completely different companies with starkly different growth profiles.

2. Moreover, *no* evidence at trial supported a 4.0% perpetuity growth rate for DFC. In fact, petitioners' expert Kevin Dages proposed the 3.1% growth rate, and at trial never advanced a growth rate above 3.5%. *See* Op. at 48. Mr. Dages explained that, based on his "review of economists' long-term growth estimates, [DFC's] management projections and long-term growth rates in the record," it was his "opinion that a reasonable long-term growth rate falls between the average estimates of the inflation rate (2.3%) and the risk-free rate as of the Appraisal Date (3.1%)." A879–80 (emphasis added). Mr. Dages presented valuations using a 2.7% perpetuity growth rate, "the midpoint of my estimated range of a reasonable long-term growth rate," and 3.1%, a "higher midpoint terminal value perpetuity growth rate." A880, A904. He opined that his "DCF models support[] a stable growth rate in excess of the maximum 3.1%," but never even suggested a perpetuity growth rate above "3.5%." A901, A905.[2]

[2] Petitioners claimed at trial that DFC's expert Daniel Beaulne's model "implied" a perpetuity growth rate of 4.5%. That is simply false. Mr. Beaulne testified that because DFC's long-term growth was uncertain, he utilized a "convergence" growth model deliberately to avoid selecting a perpetuity growth rate. A307, A351–52. He flatly rejected a 4.5% perpetuity growth rate and

The Court of Chancery adopted Mr. Dages's 3.1% perpetuity growth rate through detailed and reasoned analysis, finding that it "appears in line with market theory and this Court's precedents." Op. at 49. The court explained that it "often selects a perpetuity growth rate based on a reasonable premium to inflation [2.31%]," and that the 3.1% growth rate "represents a reasonable premium of 79 basis points over inflation." Op. at 49–50. Indeed, the Court of Chancery regularly selects perpetuity growth rates in this same, narrow range.[3]

The Court of Chancery's stated justification for changing the perpetuity growth rate to 4.0% makes no sense. The court posited that the five-year working capital assumptions in the March Projections (which the court had inadvertently excluded from its original cash-flow model, in favor of a different set of working capital assumptions the court had expressly rejected in its original opinion), required increasing the perpetuity growth rate. Ex. B at 4–6. But there was no evidence at trial that the March Projections' working capital assumptions required a higher perpetuity growth rate. Indeed, petitioners' model assumed *both* the March Projections' working capital *and* the 3.1% perpetuity growth rate. *See*

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explained that petitioners' attempts to impute any perpetuity growth rate to his model were "misleading" and "not appropriate." *Id.*

[3] *See, e.g.*, *Owen v. Cannon*, 2015 WL 3819204, at *26 (Del. Ch. June 17, 2015) ("the terminal growth rate I adopt (3%) should not be controversial"); *Cede & Co. v. JRC Acquisition Corp.*, 2004 WL 286963, at *6 (Del. Ch. Feb. 10, 2004) (3.5% perpetuity growth rate); *Towerview LLC*, 2013 WL 3316186, at *26–27 (2.25% perpetuity growth rate).

A904 (Dages explaining that his cash-flow model used both "the March Projections … and terminal growth rate of 3.1%."). *No one* suggested they were inconsistent.

The petitioners (and the court in its original opinion) were correct that the March Projections did not require a higher perpetuity growth rate. The March Projections involved a five-year forecast for what everyone agreed would be an unpredictable and extraordinary period for DFC, given DFC's near-term regulatory uncertainty. There is simply no basis for using these *short-term* projections as a basis for dramatically increasing the *perpetuity* growth rate of the company.

The Court of Chancery's finding that DFC had not yet "reached a stable state" (Ex. B at 5), further proves the impropriety of basing the perpetuity growth rate on five-year projections. The fundamental premise of the Gordon Growth Model (which the trial court adopted for the terminal value in its discounted cash flow calculation) is that a company's growth will eventually stabilize, and the perpetuity growth rate should reflect what that company will look like *in its stable state*.[4] The Court of Chancery's decision to use a high perpetuity growth rate based on extraordinary, *non*-stable-state, near-term projections is unsupportable.

[4] *See* Aswath Damodaran, *Investment Valuation: Tools and Techniques for Determining the Value of Any Company*, 323–24 (2002) ("The Gordon growth model can be used to value a firm that is in 'steady state' with dividends growing at a rate that can be sustained forever."); Lorenzo Carver, *Venture Capital Valuation: Case Studies and Methodologies*, 87 (2011) (same).

3. The *only* virtue of altering the perpetuity growth rate from 3.1% to 4.0%—to the extent one considers this a virtue at all—is that it left the overall "fair value" determination essentially unchanged from the court's original opinion. But if the court had followed the extensive analysis contained in its own original opinion and simply corrected its own inadvertent input error, it would have reached a discounted cash flow valuation of $7.70 per share, a full *42% less* than the court's final discounted cash flow valuation of $13.33 per share. These wild swings in valuation outputs based on modest manipulation of model inputs demonstrates beyond doubt the unreliable and arbitrary nature of the discounted cash flow approach. *See, e.g.*, Janet Lowe, *The Triumph of Value Investing: Smart Money Tactics for the Postrecession Era* 105 (2010) (explaining that the discounted cash flow approach "is subject to the saying, 'garbage in, garbage out'" and that "[s]mall changes in inputs can result in large and often misleading changes in the perceived value of a company").

Indeed, a legal determination that adds millions of dollars to an acquisition price negotiated at arm's length, based on such arbitrary determinations, is fundamentally inconsistent with due process, which forbids the "arbitrary determination of [a damages] award's amount" that "reflect[s] not an application of law, but a decisionmaker's caprice," *Philip Morris USA v. Williams*, 549 U.S. 346, 352 (2007) (internal quotation marks and citation omitted).

CONCLUSION

For the reasons set forth herein, the Court should vacate the trial court's order and final judgment, and instruct the court either (1) to find that the transaction price represents the "fair value" of DFC shares, or (2) to return to its original "fair value" determination but correct the undisputed, inadvertent error in its original discounted cash flow analysis.

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