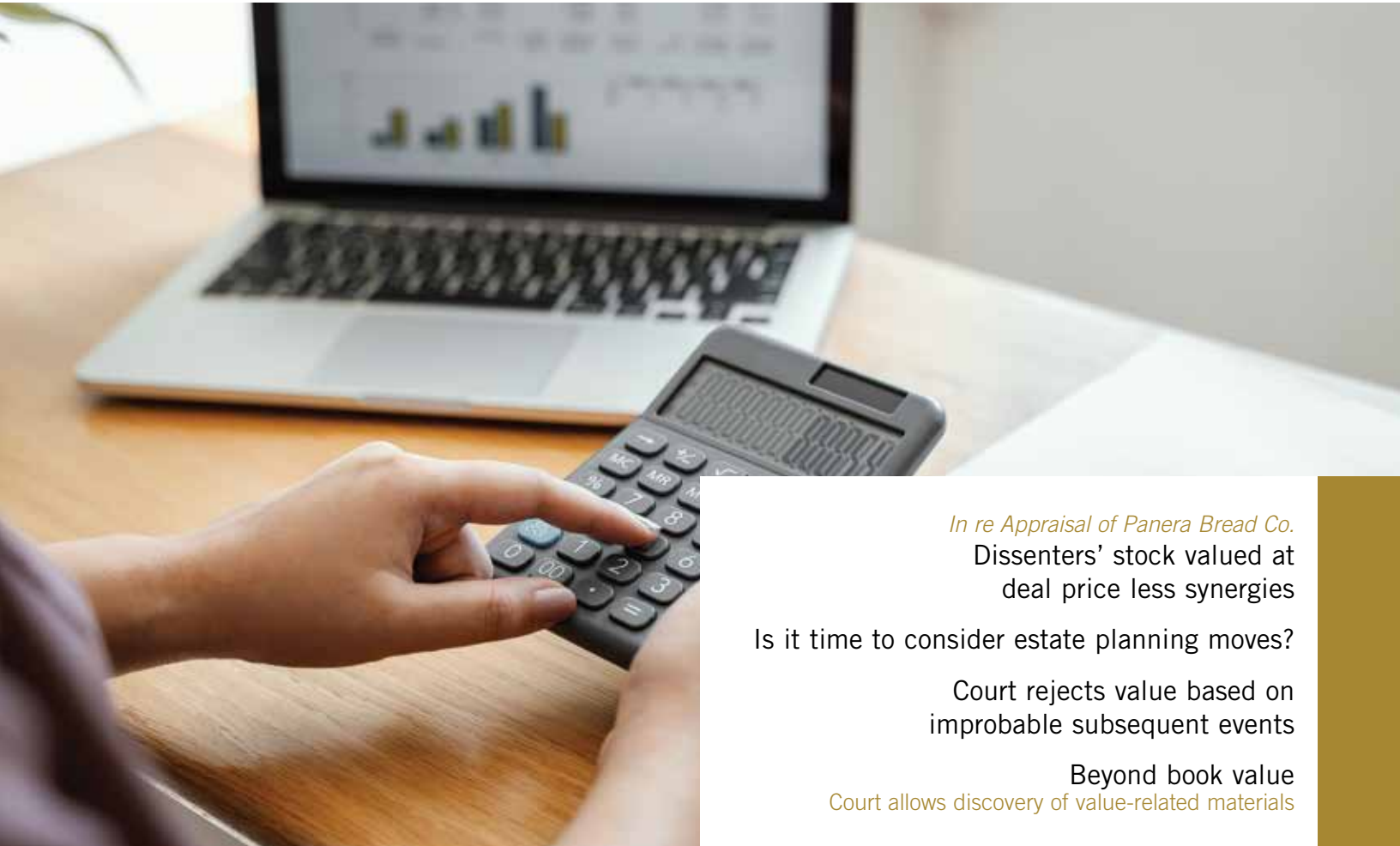


# ADVOCATE'S EDGE



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deal price less synergies

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improbable subsequent events

Beyond book value  
Court allows discovery of value-related materials

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## *In re Appraisal of Panera Bread Co.*

# Dissenters' stock valued at deal price less synergies

Once again, a Delaware court has turned to deal price as the most reliable indicator of a company's fair value in a statutory appraisal proceeding. Interestingly, the dissenting shareholders received the unadjusted fair value of their shares, even though the Delaware Chancery Court found that a downward adjustment for cost- and tax-related "synergies" was justified.

### Valuation dispute

Panera Bread is a national bakery-cafe chain in the United States and Canada. JAB Holdings B.V. purchased Panera in July 2017 for \$315 per share. After the acquisition, dissenting shareholders with about 785,000 shares of the company's common stock demanded an appraisal of their shares.

The shareholders' business valuation expert concluded that the fair value was \$361 per share. The expert arrived at this figure by giving 60% weight to a discounted cash flow model, 30% weight to an analysis of comparable companies and no weight to analyses of prior transactions involving the company's stock. He also gave no weight to the deal price.

During trial, Panera's valuation expert countered that the fair value was \$304.44 per share, based on deal price less synergies. In post-trial briefing, that value was reduced to \$293.44. The company sought a refund for the difference between its prepayment of \$315 per share and the fair value.

### Court decision

The chancery court began its analysis by noting that the Delaware Supreme Court has endorsed the position that the deal price often is the most reliable evidence of fair value. That said, the state high court



has acknowledged that the market isn't always the best indicator, stating that, "the persuasiveness of the deal price depends on the reliability of the sale process that generated it." If the process isn't open or sufficiently reliable, the deal price isn't persuasive.

The chancery court found the following objective indicia of the Panera sale process's reliability:

- It was an arm's-length transaction.
- The board of directors was disinterested and independent.
- The buyer based its assessment of Panera's value on the company's extensive public information and focused due diligence on its confidential information.
- Panera's board was able to extract two price increases from the buyer.
- No other potential bidders emerged, despite a leak during negotiations.
- Panera solicited all logical buyers (that is, JAB and Starbucks), consistent with its knowledge of the company's value and the market.

The court noted some flaws in the sales process, however. For example, Panera's founder and CEO

### 3 alternative methods come up short

The Delaware Chancery Court in Panera (see main article) considered — but ultimately rejected — the following three alternative sources of valuation evidence:

**1. Discounted cash flow (DCF) analysis.** The chancery court found flaws with both experts' DCF analyses. The court noted that the Delaware Supreme Court has cautioned against using the DCF method when market-based indicators are available. It concluded that neither DCF valuation was sufficiently reliable compared to the reliable market-based deal price.

**2. Guideline company data.** Both experts analyzed comparable (guideline) companies, but the chancery court found that neither analysis established a suitable peer group for comparison. In fact, the court found both analyses merely to be attempts to corroborate the parties' respective preferred valuations.

**3. Prior transactions involving the company's stock.** The court dismissed the experts' analyses of precedent transactions. The shareholders' expert used data from three earlier transactions, while the company's expert reviewed 11 previous transactions. However, the court determined that neither sample size was reliable enough to afford it weight.

If a valuation expert chooses not to use alternative sources as a primary valuation method, they may still serve as a "reasonableness check" to help justify the value determined by the primary method.

pushed for an offer "not deep in the 300s" before the board received a full valuation. In addition, the board's financial advisor had previously worked for the buyer. Ultimately, the court determined that such weaknesses didn't undermine the indicia of reliability.

### Deduction for synergies

Next, the chancery court considered the synergies produced by the transaction. The court explained that it must exclude from any appraisal award the amount of value the shareholders would receive because the buyer intends to operate the company as part of a larger enterprise that can produce synergistic gains.

The company cited three categories of synergies: 1) incremental cost savings, 2) incremental leverage tax benefits, and 3) revenue synergies. The shareholders asserted that JAB was a financial sponsor, not a strategic buyer, and challenged the company's evidence of synergies.

The court sided partially with Panera. It found that the company established a deduction from the deal price for cost and tax synergies of \$11.56

per share. But it also concluded that the company failed to prove its \$10 adjustment for revenue synergies. As a result, the court found that the fair value per share was \$303.44 after adjusting for synergies (\$315 – \$11.56).

The Delaware Supreme Court has endorsed the position that the deal price often is the most reliable evidence of fair value.

### Refund denied

The deductions for synergies weren't particularly relevant, however, because the company had prepaid its shareholders the entire deal price. The parties didn't agree to a clawback provision in the event of overpayment, and the Delaware appraisal statute doesn't explicitly include a refund mechanism. The court, therefore, declined to order a refund, leaving the shareholders with more than fair value. ■

# Is it time to consider estate planning moves?

**B**usinesses and the financial markets have incurred major losses in the first half of 2020 due to the novel coronavirus (COVID-19) crisis. But there's an upside: Low asset values and favorable tax laws could create opportunities for wealthy individuals to gift certain assets, including business interests and intangible assets, to family members and charities. But this opportunity won't last forever.

## Favorable tax laws

The Tax Cuts and Jobs Act (TCJA) doubled the federal gift and estate tax exemption per individual from \$5 million to \$10 million, with annual indexing for inflation. For 2020, the inflation-indexed exemption is \$11.58 million, or effectively \$23.16 million for a married couple. Unfortunately, these generous exemptions are set to expire on December 31, 2025. And they could be reduced sooner if Congress needs revenue to fund expenditures.

Chances are good that most business owners will outlive today's generous gift and estate tax

exemption. But, the fair market value of gifts of business interests to family members, loyal employees or charities made in 2020 may count toward the owner's lifetime exemption — which means they would be tax free.

In addition, for 2020, taxpayers can transfer \$15,000 per recipient under the annual gift tax exclusion free of federal gift tax without tapping into their lifetime federal gift and estate exemption.

Suppose an unmarried business owner gifts private stock valued at \$1,150,000 to ten family members in 2020. After the annual gift tax exclusion is applied to \$150,000 of gifts, the lifetime exemption can shelter the remaining \$1 million from gift tax. That leaves an available estate tax exemption of \$10.58 million (assuming the business owner hadn't tapped into her lifetime exemption in a previous year).

## No clawbacks

The IRS issued proposed regulations in 2018 that would prevent these gifts from being "clawed back" and hit with estate taxes if the exemption is lower when they die. Under the proposal, the applicable exemption amount is the greater of:

- The exemption amount used to shelter gifts made from 2018 through 2025, or
- The exemption amount that's applicable in the post-2025 year of death.

If the IRS proposal is finalized, a qualified business appraisal can help maximize the exemption amount used up before the expanded exemption limit expires.

**Warning:** Some states impose estate or inheritance tax at a lower threshold than the federal government does. So, learn the rules in your state to avoid an unexpected tax liability or other unintended consequences of an asset transfer.



## Fair market value

A business valuation is essential to determine how many ownership interests in a private business can be gifted without incurring gift tax — or how much can be deducted for a charitable donation. It also helps business owners formulate a long-term strategy for transferring their wealth.

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Do-it-yourself appraisals may raise a red flag with the IRS. Instead, consider hiring a business valuation professional to determine fair market value. Under IRS Revenue Ruling 59-60, valuers consider eight factors when valuing a private business:

1. Its nature and history,
2. The outlook for the industry and economy,

3. The company's book value and financial condition,
4. Its earnings capacity,
5. How much dividends the company could (or does) pay out,
6. The value of goodwill and other intangible assets,
7. Prior sales of the company's stock and the size of the block, and
8. The price paid in comparable stock transactions.

In addition, smaller ownership interests may be eligible for discounts for lack of control and marketability. Valuation experts use real-world empirical data to support their analyses, rather than gut instincts or industry rules of thumb.

## Strike while the iron is hot

It's important for private business owners to monitor the value of their interests and meet regularly with estate tax professionals to discuss estate planning options. Gifting (or donating) ownership interests while values are low and tax rates are favorable can dramatically lower exposure to estate tax. Contact your valuation advisor for more information. ■

# Court rejects value based on improbable subsequent events

The U.S. Tax Court in *Grieve v. Commissioner* was required to determine the fair market value of a nonvoting stake in a limited liability company (LLC) for gift tax purposes. Here's why the court sided with the taxpayer — and why it pays to hire a business valuation professional.

## Battling experts

The taxpayer set up an LLC and contributed about \$9.1 million worth of publicly traded stock to it.

The LLC then distributed 20 voting class A units to the taxpayer's daughter and 9,980 nonvoting class B units to a grantor retained annuity trust (GRAT).

The daughter was the chief manager of the LLC. Holders of class A units possessed voting powers for all purposes. Class B units couldn't vote on or participate in any proceedings in which the entity or its members took action. The LLC agreement also contained various provisions that restricted transfers of membership units.

The taxpayer hired an outside valuation expert to value its gift of the class B units. Although the gift represented 99.8% of the LLC's total units, the expert valued the gift at only \$5.9 million, or only 65% of the LLC's total value, due to lack-of-control and marketability discounts of 13.4% and 25%, respectively.

In Tax Court, an expert's written valuation report often serves as his or her direct testimony during trial.

The IRS disputed the gift's value. Its expert valued the gift at \$9 million or 99% of the LLC's value. He assumed that any willing seller of the class B units would first look to acquire control of the 0.2% interest held by the class A unit holder to avoid the large discounts that a willing buyer would seek for merely buying the class B units.

### Ruling in favor of taxpayer

The IRS's valuation was contingent on an additional action in the future: the purchase of the class A units. Further, the expert reasoned that the economic stake of the holder of a 99.8% interest of the class B units "dwarfs" that of the holder of the class A units;

thus, there shouldn't be a big discount to the value of the class B units.

The court rejected the IRS's reasoning. The daughter, the sole owner of the class A units, testified that she had no intention of selling the units and, if she ever sold the units, she would demand a premium much higher than what was estimated in the IRS's valuation. In addition, if the class B units were ever sold outside the family, the daughter explained that she would require a management fee. The court decided that these facts supported a 35% combined discount for the class B units.

In addition, the court looked at the value of the class B units on the date of the gift — *not* the value of the class B units based on subsequent events that, while within the realm of possibility, weren't reasonably probable. The court also wasn't concerned with the value of the class A units. As a result, the court agreed with the \$5.9 million valuation set forth by the taxpayer's expert.

### Expertise is key

In Tax Court, an expert's written valuation report often serves as his or her direct testimony during trial. So, it's important to hire a qualified specialist who can explain his or her analysis in a comprehensive manner. Speculative or improbable assumptions that aren't known or knowable at the time of valuation are unlikely to pass muster. ■



# Beyond book value

## Court allows discovery of value-related materials

A divorce case in Florida has produced an important discovery ruling about a spouse's right to information from a non-party business that might indicate the value of a marital asset. The ruling could be welcome news for other divorce litigants seeking equitable distributions.

### Husband seeks access

In *Hall*, the wife held a fractional ownership interest in a large medical practice. Her husband subpoenaed the practice for 16 categories of documents that might shed light on the value of the wife's ownership interest.

The medical practice moved for a protective order. It argued that, under the practice's operating agreement, the value of the wife's interest was predetermined by the practice's "book value," as determined by its accountant. The trial court denied the husband access to those records, and he appealed.

### Appeals court grants limited discovery

The Florida Court of Appeals came down on the side of the husband — at least partially. It noted that the operating agreement defined the value of an interest in the practice only under limited circumstances, such as on the death or termination of an owner.

The husband argued that those none of these circumstances would occur as a result of the divorce. He claimed he was entitled to reasonable discovery from the practice to determine the value of the wife's interest under fair market value or any other relevant standard of value.

The appellate court agreed. If the wife's interest was a marital asset, its value must be determined and considered by the court when conducting its equitable distribution analysis. Information related to the practice's value was discoverable because



it may be admissible or lead to the discovery of admissible evidence.

The court also pointed out that "book value," as defined in the operating agreement, didn't include the value of the practice's accounts receivable or goodwill. The practice's expert admitted that book value wasn't the same as the practice's fair market value.

But the court didn't grant the husband access to all the subpoenaed documents. It limited discovery to information about stock options, stock purchases since 2012, stock appraisals and offers to purchase the practice in the previous five years. The appellate court also instructed the trial court to limit the use of the documents to this particular case and prohibit disclosure to others.

### Be aggressive

Because the husband in *Hall* didn't settle for accepting the practice's book value, it's likely that he'll receive a larger distribution from the marital estate. The lesson? Comprehensive discovery, which looks beyond the operating agreement and other internal documents for evidence of business value, can help ensure a fair and equitable distribution of marital assets. ■

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