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Appraisal and Merger Synergies—Right to a Refund on Prepayments

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In *In Re Appraisal of Panera Bread Company* (Dec. 31, 2019), the Delaware Court of Chancery found that the sale process relating to the $7.5 billion acquisition of Panera Bread Company by JAB Holdings B.V. was sufficient for the court to rely on the deal price to determine appraised fair value. The court also found that JAB provided sufficient evidence for the court to deduct from the deal price the value of certain expected merger synergies (pursuant to the statutory mandate to exclude from fair value any value "arising from the merger itself"). The appraisal result was about 3.7% below the deal price. Finally, in a matter of first impression, the court ruled that JAB–which had prepaid the appraisal claimants based on the full deal price, was not entitled under the appraisal statute to a refund on the prepayment.

Key Points

- **The decision is one of the few in which the court has actually made a deduction from the deal price for the value of expected merger synergies**. In recent years, the court has frequently acknowledged that, when the court relies on the deal price to determine fair value, the appraisal statute mandates a deduction for any value "arising from the merger itself" (such as the value of merger synergies). The court has not often made a deduction, however, as, in most cases, the court has considered the evidence offered by the buyer insufficient to establish the value of merger synergies and/or the extent to which that value was reflected in the deal price. In this case, the court deducted the value of expected cost-savings and tax benefits (but not revenue synergies). We note that the risk of at-or-below-the-deal-price appraisal results has significantly discouraged the filing of appraisal claims in the context of arm's-length third parties mergers without seriously flawed sale processes.
- **The court addressed the open issue whether a deduction for merger synergies would be made even when the synergies could have been achieved by the target company itself without a merger.** The court appears to have answered "yes"–at least where the evidence reflects that the target, if it had remained a standalone entity, likely

would not have made the changes necessary to achieve that value (which, in *Panera* was the case, the court concluded, in light of the target's "management culture and priorities").

- **The decision highlights that, depending on the circumstances, a deduction for merger synergies may be made even in the context of a transaction involving a "financial" buyer.** In this case, the transaction was strategic for the buyer in "filling gaps" in its portfolio of companies in the same space as the target; the buyer was utilizing its "characteristic framework for creating value" that had achieved synergistic value in previous deals; the target's "management culture and priorities" would not "support" the changes the buyer contemplated; and, apparently critically, the buyer's financial modeling had included the anticipated synergies from the outset of its process.
- **Under the appraisal statute, a buyer that has pre-paid an amount that is higher than the court's ultimate determination of appraised fair value is not entitled to a refund.** While this is generally what had been expected with respect to prepayments, the court had not previously addressed the issue. The ruling underscores that, as part of a prepayment of an appraisal award, the buyer should negotiate with the appraisal petitioners a contractual claw-back right in the event that the prepayment amount exceeds the court's ultimate determination of fair value.
- **The case serves as a reminder that, notwithstanding the decline in appraisal risk in the past couple of years, appraisal claims may still be made–even in the context of a third party arm's-length merger–if there are perceived flaws in the sale process.** In this case, the appraisal petitioners focused on there having been only two potential buyers contacted in the process (and then a passive-only post-signing market check) and alleged conflicts of the lead negotiator given that he had personal reasons for wanting the company to be sold. The court found that the sale process was sufficient for judicial reliance on the deal price to determine fair value. Of note, the court emphasized that the board's "deep" and "impeccable" knowledge about the company and the industry and its "facility" with the company's financial forecasts and results served as a strong basis of support for its decisions. The court also noted the CEO's longstanding efforts to create value for the company and record of putting the company's interests before his own.

Background

Ronald Shaich (RS), the founder, CEO, Executive Chairman, and largest stockholder of Panera (owning, at the time of the merger, about 6% of the outstanding shares), informed the board in early 2015 that he wanted to step away from Panera and pursue other endeavors. While the board worked on a succession plan and implemented Shaich's numerous initiatives for the company, Shaich annually reminded the board of his desire to leave. In May 2015, the board considered strategic alternatives with the advice of a financial advisor ("G"). G concluded that financial buyers would not have any interest in Panera and identified a "limited number" of potential strategic buyers, with Starbucks as the most likely. The board determined not to pursue a sale at that time. In mid-2016, Starbucks contacted Panera about an acquisition, but soon called off the talks, saying that Starbucks could not pay Panera's public market price let alone a premium and that "there were other things going on within Starbucks." At the same time, Schaich, on his own initiative, asked G to facilitate an introductory meeting with JAB. In February 2017, Schaich met with JAB and JAB expressed interest in an acquisition. Schaich informed the full board at its March 1 meeting, but did not mention that it was he who had initiated the conversation with JAB. The board authorized Shaich to continue the discussions and report back.

On March 10, 2017, JAB offered to acquire Panera for $286 per share (which represented a 21.7% premium to the then trading price). JAB, following its usual "playbook," conditioned its offer on a confidentiality provision, a no-shop with a fiduciary out, matching rights, and a 4% termination fee. There was no financing condition and JAB wanted to sign by April 7. JAB used G for the financing (despite Panera's previous relationship with G). JAB recommended two bankers to Panera for the transaction (including "M," who was JAB's coverage banker at a major financial advisor) and stated that it was important that Panera use a banker who was "familiar with JAB's playbook." Shaich recommended these bankers to Panera's board but did not tell the board that JAB had suggested them. The board, at the recommendation of its outside legal counsel, engaged "B," a banker at M who had never worked for JAB.

The Panera board rejected the $286 offer and told JAB that it would have to significantly raise the price. M cautioned Shaich against "pushing too hard" for a higher price. The next day, Shaich informed JAB that it would have to increase its price to "north of $300." A few days later, JAB made an offer of $296.50 (a 16.2% premium to that day's trading price) and insisted that it could never go above $299. After talking with the board, Shaich told JAB that the offer price still had to increase significantly. The parties agreed to work toward entering into a definitive agreement the week of April 3. On March 27, JAB provided Panera with a draft merger agreement. That same day, there was a leak about the deal. At the March 30 Panera board meeting, M presented its valuations and identified "Potential Interlopers," which were the same companies G had previously suggested as the potential buyers for Panera. M ruled out financial sponsors having any interest (as G also had). M's analysis was the same as Shaich's and the board's, which was that none of these parties was a feasible buyer (for example, Starbucks because it had just recently passed on Panera; Chipotle, because it was in the midst of an *E. coli* crisis; and other parties because they were franchise-only operations, had just made major acquisitions, and/or various other reasons.

On April 3, 2017, Bloomberg reported that Panera was evaluating strategic alternatives including a possible sale of the company to suitors such as JAB and Starbucks. In response, Panera's stock rose 8%, to $261.87. On the same day, Panera countered JAB's draft merger agreement. JAB responded with a "best and final offer" of $315 per share and a 3% termination fee. The $315 offer represented a 34.1% premium to the March 10 trading price and a 20.3% premium to the March 31 pre-leak trading price. The board discussed the transaction and M's valuations; M delivered a fairness opinion; and the board approved the merger. On April 5, the merger agreement was signed and the deal was announced. Panera stockholders approved the merger, with more than 80% of the shares voting and more than 97% of the votes cast in favor. The merger closed on July 18, 2017. No potential competing bids emerged at any time.

Thirty stockholders, holding about two million shares, exercised appraisal rights. In the appraisal trial, the petitioners contended that the fair value per share was $361, based on their DCF analysis (weighted 60% in their analysis), comparable companies analysis (30%), and precedential transactions analysis (10%). JAB contended that fair value was $304.44 per share, based 100% on the deal price less merger synergies. In post-trial briefing, JAB lowered its fair value determination to $293.44 per share based on additional synergies that it argued should be deducted from the deal price. Between December 2017 and May 2018, Panera pre-paid the dissenting stockholders the full amount of the deal price ($315 per share) plus statutory interest accrued through the payment date for all of the shares they beneficially owned. Vice Chancellor

Zurn relied 100% on the deal-price-less-synergies, determined fair value to be $303.44 per share, and ruled that JAB was not entitled to a refund on its prepayment).

Discussion

The court found the sale process to be the most reliable indicator of appraised fair value. The decision reaffirms that (as the Delaware Supreme Court established in *Aruba* (Apr. 16, 2019)) the court will rely on the deal price to determine fair value when the sale process is viewed as sufficiently probative of fair value. In this case, the court viewed the sale process as sufficient. Notably, the per share deal price represented a 34% premium over the unaffected stock price; there were two increases in the offer price (even though JAB initially insisted that it would not offer more than $299 per share); extensive public information about Panera was available; and no other bidder emerged (neither pre-signing–notwithstanding a leak about the deal; nor post-signing–notwithstanding routine, "nonpreclusive" deal protections). The sale process involved the following:

- ***Only two parties contacted pre-signing.*** There was no "active survey of the market." The court stated that all that is required is outreach to "the logical buyers." The court credited the board with having "impeccable knowledge" about the company and the market, which supported their conclusion that Starbucks and JAB were the only logical buyers.
- ***Reasonable termination fee.*** The court characterized the 3% fee as at the "low end of the range" presented by other deals. The court referenced deals with fees of 2.27%, 3.5% and 9%.
- ***Typical no-shop and matching rights.*** The court stated that the no-shop provision, which included matching rights and a fiduciary out for a "superior" offer if one emerged on an unsolicited basis, did not differ meaningfully from the provisions in other deals that the court has viewed as "satisfying enhanced scrutiny."
- ***Passive-only post-signing market check***. The court viewed the 104-day period between signing and closing as "[falling] in the middle" of the range presented by other deals. The court referenced deals with signing-to-closing periods of 50, 126 and 153 days.

To determine appraised fair value, the court excluded from the deal price the value of certain expected merger synergies. JAB contended that the court should exclude $21.56 per share for synergies anticipated ("and paid for") by JAB for "deploying [its] characteristic management framework." The three categories of expected synergies that JAB identified were: "incremental cost savings, incremental leverage tax benefits, and revenue synergies." The court rejected the petitioners' argument that these expected synergies should not be excluded because they could have been accomplished by Panera itself, without a merger. The court concluded: "That is not true" because "Panera's management culture and priorities did not support the changes JAB intended to make."

- ***Cost Savings.*** The court observed the significant "differences in scale" between Panera's cost-saving expectations and JAB's. "As an example, Panera evaluated…G&A savings in its forecast, predicting new cost savings between $300,000 and $600,000 each year from 2018-2021," while "JAB projected $18 million in the first year alone." The court wrote: "JAB believed it could achieve much greater savings because of its expertise

in executing those savings across their portfolio companies" and because of a different philosophy than Panera's in terms of use of capital (which related to the timing of paying vendors and Panera's approach of always sourcing "the best" notwithstanding cost).

- ***Tax Benefits from increasing Panera's leverage.*** The petitioners argued that Panera could "re-leverage its balance sheet as it saw fit so that the tax deductions associated with JAB's $3 billion financing" would not be an element of value arising from the merger. The court noted that, in this case ("unlike in *Huff*," where the court rejected a deduction for anticipated merger synergies by the financial buyer in that case), "the evidence shows that JAB had similarly financed other deals in the past and saw value in doing it again with Panera, while Panera intentionally maintained low debt." The court concluded: "The preponderance of the evidence demonstrates that JAB formed its initial offer in view of that predicted value. JAB confirmed it could realize that value during due diligence, and that conclusion informed [its] offer price."
- ***Revenue Synergies***. The court declined to exclude the value of expected revenue synergies. The court wrote: "Unlike the cost and cash playbook prongs, JAB did not quantify these growth opportunities in its models." The court noted that "JAB recognized that, while it is relatively simplistic to quantify potential cost savings, it is much more difficult to quantify for-sure growth areas, even though they may be extremely important." Moreover, the court wrote: "Leading up to and throughout trial, [JAB] and its expert presented a fair value that did not quantify any revenue synergies attributable to JAB's growth opportunities." JAB's post-trial position on revenue synergies represented "conclusory fact testimony contradicted by JAB's contemporaneous financial modeling and rejected by its expert."

See our memorandum, *Another Nail in the Coffin for Arm's-Length Merger Appraisal Cases Without Fatal Process Flaws–Delaware Supreme Court Embraces the Merger-Price-Less-Synergies Approach for Determining 'Fair Value'*–Aruba *(Apr. 2019)*.

The court ruled that there is no right under the Delaware appraisal statute to a refund of a prepayment that exceeds the later-determined appraisal award. DGCL Section 262(h) permits a corporation that is the subject of an appraisal proceeding to prepay appraisal claimants in cash any amount the corporation determines and, by so doing, to stop the accrual of interest on the prepaid amount. The statutory rate of interest is 5% above the Federal Reserve discount rate, compounded quarterly, payable from the date the appraisal action is filed through the date on which the appraisal amount is paid. Prepayment (which is permitted any time prior to entry of judgment in the appraisal) thus permits the corporation to reduce the interest expense on an appraisal award and to minimize arbitrage by dissenting stockholders based on the relatively high interest rate. The statute is silent with respect to a refund if the prepayment turns out to have exceeded the appraisal amount the court later determines. Vice Chancellor Zurn reasoned that, because appraisal is "entirely a creature of statute," and because the statute is silent with respect to refunds of prepayments, "the only permissible conclusion" is that a refund mechanism was intentionally omitted, and therefore the court "cannot order one." The Vice Chancellor commented in dictum that denying a refund "[did] not offend [his] sensibilities" because a company's "[p]repayment under the DGCL is a business decision, made with knowledge of the company's sale process that is superior to the stockholder's, and with counsel's prediction of how long the litigation may take and how much interest may accrue." The court noted that JAB had not negotiated with the appraisal claimants a "claw-back right" to the extent the prepayment was an overpayment.

Practice Points

- ***A buyer should carefully evaluate whether, when and in what amount to make prepayment of an appraisal award–and, if prepayment is made, should negotiate a claw-back right***. The key reason to prepay is to stop the accrual (on the prepaid amount) of the relatively high statutory interest payable on the appraisal award–and so to reduce both interest cost and uncertainty. Thus, a key consideration is how the company's cost of capital for unsecured debt compares to the statutory interest rate. The determination of when to make a prepayment depends on how long the appraisal proceeding is likely to last, when the corporation would have the funds available to make a prepayment, and the extent of the risk of having to make payment in full of the appraisal award plus all accrued interest when the court issues its decision. At the same time, a prepayment would free up the dissenting stockholders' capital that otherwise would be tied up for length of the proceeding (typically, roughly two years); and, as a result, could make settlement more difficult. The determination of the amount of a prepayment also involves numerous considerations. The amount prepaid could be viewed as reflecting the buyer's expectation as to the likely determination of fair value. Moreover, if the prepayment exceeds the ultimate fair value determination, there is no right to a refund (if the prepayment amount exceeds the court's eventual appraisal award) unless the buyer negotiated a claw-back right.
- ***To substantiate a deduction of the value of expected merger synergies, a buyer should (from or near the outset of the process) include that value in its financial modeling for the deal and should confirm its expectations during its due diligence review of the target company***. As noted, merger synergies are potentially deductible even in the context of a transaction with a financial buyer–particularly if the transaction itself is strategic given the buyer's portfolio; the buyer is implementing its usual "framework" that has been successful in other deals; and the target company's "management culture and priorities" indicate that the changes would not be made (or would be made on a far lesser scale) if the company continued as a standalone entity.
- ***A target company should seek to ensure a reliable sale process.*** A reliable process should produce the best result for shareholders; minimize the potential for injunction of the deal; decrease the potential for liability for the directors and officers; and reduce the risk of reputational damage for the directors and officers. *Panera* offers a reminder that a board's "deep knowledge" of the company and its market, and "facility with" the company's financial position, will provide a sound basis for supporting its decision-making. In evaluating the appraisal risk associated with a deal, the buyer must try to assess the reliability of the target's sale process (a task which, we note, will be done with imperfect information).