IN THIS ISSUE

Value Matters™

Issue No. 1, 2014

Koons v. Commissioner

It appears that Mr. Koons' careful estate planning, involving a significant sale and redemption transaction of business operations to provide liquidity and flexibility in his later years, was disrupted by an untimely death. While estate planning professionals can hardly advise against a premature passing, the disruption here highlights the importance of starting early with business valuation input to help avoid a complex confluence of strategic transactions within a narrow time frame.

Key Issues

The Court rejected the Estate's claim seeking a 31.7% marketability discount applied to a Revocable Trust's ownership interest in a family-owned Limited Liability Company. The Estate's expert calculated a marketability discount through a regression analysis. It was his opinion that a substantial risk existed that the Trust's contemplated redemptions of Member Interests, contracted for as part of a planned redemption, might not be consummated. The contemplated redemptions would place the Trust in a voting control position.

The Court agreed with the IRS expert's conclusion that the referenced redemption offers were binding contracts and were expected to be consummated. The lower risk implicit in the likelihood of a transaction, in context with the implicit voting control position, resulted in the IRS marketability discount of 7.5%, which was accepted by the Court.

The Court also held that claimed interest expense in the amount of $71,419,497 on a $10,750,000 loan from CI LLC to the John F. Koons III Revocable Trust is not deductible to the Estate as an essential expense. The Trust had borrowed the $10.75 million from the LLC in order to pay estate taxes.

Background

John Koons III (the "decedent" or "Koons") died on March 3, 2005. At issue before the court was the value of his interest in his Revocable Trust (the "Trust'), as well as the deductibility of claimed interest expense on a loan which was incurred by the Trust to make payments on the estate tax liability.

In 1934, the father of John Koons III began buying shares in the Burger Brewing Co., which owned and operated a Cincinnati brewery. The decedent also purchased shares and later became the company's president and CEO. Under Koons' leadership, the company began bottling and distributing Pepsi soft drink products in the 1960s. In the 1970s the company stopped brewing beer altogether, and changed its name to Central Investment Corp. ("CIC"). Diversifying its business further, it expanded into the business of selling food and drinks from vending machines.

In 1997, CIC was in a dispute with PepsiCo about whether CIC had the exclusive right to sell Pepsi fountain syrup directly to restaurants, movie theatres, and other customers in its territory. Litigation ensued, and PepsiCo eventually suggested that the lawsuit could be settled if CIC exited the Pepsi system. CIC negotiated with PepsiAmericas, Inc., ("PAS"), the nation's second largest Pepsi-Cola bottling company. Negotiations were expanded to include the sale of CIC's vending-machine business.

In preparation for the sale of its soft drink and vending machine business, Central Investment LLC ("CI LLC") was set up in August 2004 as a wholly owned subsidiary of CIC, to receive all the non-soft-drink and non-vending-machine assets. Koons and his children owned the same percentage in the newly-formed CI LLC as they did in CIC. However, the children were required to approve the sale transaction. Further, their interests in CI LLC were subject to redemption agreements within 90 days of the PAS transaction.

The PAS sale transaction was effected on January 12, 2005.

On February 27, 2005 (approximately four days before the valuation date), the last of the four children signed her letter offering to redeem their respective interests in CI LLC. Mr. Koons died on March 3,

2005. Mr. Koons had already transferred his interests in CI LLC to his Revocable Trust. At his death, the Revocable Trust had a total 50.50% interest in CI LLC, which included a 46.94% voting interest and a 51.59% nonvoting interest. The net asset value of CI LLC at the date of death was $317,909,786.

The children's redemptions scheduled as part of the sale transaction took place on April 30, 2005 (approximately two months after the valuation date). With redemptions complete, the Trust (by then a Trust Under Will) owned a 70.42% voting interest and a 71.07% nonvoting interest in CI LLC.

On February 28, 2006 (approximately one year after the valuation date), the Trust borrowed $10.75 million from CI LLC to facilitate payments for Estate Tax liabilities. The Trust received a promissory note in the amount of $10,750,000 at 9.5% annual interest, with the principal and interest due in 14 equal installments of approximately $5.9 million each between August 31, 2024 and February 28, 2031. The terms of the loan prohibited prepayment. The total interest component of the 14 installments was $71,419,497. The proceeds of the loan would be used to make a payment toward the estate and gift tax liabilities.

Commentary

The parties agreed that the value of the Revocable Trust's interest in CI LLC was less than the pro rata asset value. The parties also agreed that the difference was due to the lack of marketability of the interest in CI LLC as compared to the marketability of CI LLC's assets. However, the parties disagreed on the magnitude of the marketability discount.

With Regard to the Marketability Discount

The Estate's expert considered the Trust's ownership interest in CI LLC as it existed on the date of death, i.e., a total 50.50% interest (comprised of a 46.94% voting interest and a 51.59% nonvoting interest). He developed a marketability discount through a regression analysis, and concluded that a 31.7% marketability discount was appropriate considering, among other factors, substantial risk existed that the redemptions of the children's interests might not be consummated. Of course, the redemption of the children's interests were accomplished soon after the valuation date, which resulted in the Trust owning a 70.42% voting interest and a 71.07% nonvoting interest in CI LLC.

The IRS expert believed that the redemptions of the interests of the four children would occur, and such redemptions would increase the voting power of the Trust's interest to 70.42%. In determining a marketability discount, he considered the following characteristics of the Trust's total 50.50% interest in CI LLC:

- There was only a small risk that the redemptions would not be completed;
- There were obligations imposed on CI LLC by the stock-purchase agreement, including those related to potential environmental, health, and safety liabilities;
- It was reasonable to expect that CI LLC would make cash distributions;
- There were transferability restrictions in the operating agreement;
- The owner of the Trust's interest would have had the ability to force CI LLC to distribute most of its assets once the redemptions were closed;
- Most of CI LLC's assets were liquid.

The IRS expert opined that a 5 -10% marketability discount was warranted. Within the 5 -10% range, he thought that 7.5% would reflect a reasonable compromise between a buyer and a seller.

The Court analyzed the two approaches to the marketability discount, highlighting that a key difference was the assumption of whether or not those scheduled redemptions would occur. The Court agreed with the IRS expert's assumption, applying a 7.5% marketability discount, based on the following points:

- The redemption offers were binding contracts by the time Mr. Koons died on March 3, 2005;
- CI LLC had made written offers to each of the children to redeem their interests in CI LLC on December 21, 2004;
- Each of the four children had signed an offer letter by February 27, 2005;
- Once signed, the offer letters required the children to sell their interests in CI LLC to CI LLC.

With Regard to the Interest Expense Deduction

To raise money to pay for the Estate tax liabilities, the Trust borrowed $10.75 million from CI LLC in 2006. Because the installments were deferred for over 18 years, the interest component of the installments was high: it totaled $71,419,497.

According to the Court, administration expense deductions against the gross estate are limited by regulation to such expenses as are actually and necessarily incurred in the administration of the decedent's estate, such as the collection of assets, payment of debts, and distribution of property to persons entitled to it. Expenditures not essential to the proper settlement of the estate, but incurred for the individual benefit of the heirs, legatees, or devisees, may not be taken as deductions.

Mercer Capital's

Gift, Estate, and Income Tax Compliance Services

Valuations are a critical element of successful tax planning strategies. Objective third-party valuation opinions are vital.

Mercer Capital provides objective valuations for tax compliance and has been since 1982. Our opinions of value are well-reasoned and thoroughly documented, which provide critical support for any potential challenge. The overwhelming majority of the time, our work has resulted in quiet acceptance by the IRS, state, and local taxing authorities.

Mercer Capital offers a diversity of services to clients, including efficient fees for the valuation of partnership and LLC interests, as well as the most comprehensive services for complex entities and business models.

Contact Nick Heinz (heinzn@mercercapital.com) or Tim Lee (leet@mercercapital.com) at 901.685.2120 to discuss your needs in confidence.

The Court concluded it was not necessary for the Trust to borrow the $10.75 million from CI LLC in order to pay the federal tax liabilities:

- When it borrowed the money on February 28, 2006, the Trust had a 70.42% voting control over CI LLC, and CI LLC had over $200 Million in highly liquid assets.
- The Trust had the power to force CI LLC and its Board of Managers to make a pro rata distribution to its members, including the Trust itself.
- The Trust's ability to force CI LLC to distribute assets made it unnecessary for the Trust to borrow from CI LLC.
- Lending money to the Trust did not avoid the necessity of making distributions altogether; it merely postponed the necessity. Furthermore, the Estate must remain active long enough for the loan to be repaid.
- The loan repayments are due 18 to 25 years after the death of Mr. Koons. Keeping the Estate open that long hinders the "proper settlement" of the Estate.

Since the loan was not necessary to the administration of the Estate, the projected interest to be paid under the loan is not a deductible administration expense of the Estate.

What's Important

It appears that Mr. Koons' careful estate planning, involving a significant sale and redemption transaction of business operations to provide liquidity and flexibility in his later years, was disrupted by an untimely death. The consideration of a loan component extending the life of the estate for many years beyond the date of death was an over-reach, and possibly could have been addressed after the redemption transaction. Furthermore, that redemption transaction clearly put the Trust in a voting control position. The IRS and the Court considered that contractual obligation to be a driving factor, thereby limiting the marketability discount. That controlling interest position would also likely have been addressed in a future estate planning strategy.

While estate planning professionals can hardly advise against a premature passing, the disruption here highlights the importance of starting early with business valuation input to help avoid a complex confluence of strategic transactions within a narrow time frame.

Summary Conclusion of Value Perspective

	Agreed Value of CI LLC	$317,909,786	
	Trust's Interest in the LLC	50.5%	
	Implicit Gross Value	$160,544,442	
	Estate's Position	**IRS Position**	**Court's Conclusion**
Agreed Value of CI LLC	$160,544,442	$160,544,442	$160,544,442
Marketability Discount	31.70%	7.50%	7.50%
Indicated Value	$109,651,854	$148,503,609	$148,503,609

James Graves

James E. Graves, ASA, CFA
gravesj@mercercapital.com

Recent Transactions

CenterState BANK
Davenport, Florida

acquired

First Southern Bank
Boca Raton, Florida

Mercer Capital issued a fairness opinion on behalf of First Southern Bancorp

International Lottery & Totalizator Systems, Inc.
Vista, California

Mercer Capital served as the financial advisor to the Special Committee of the Board of Directors and issued a fairness opinion on behalf of the minority shareholders in a Going Private transaction

In addition to valuation services, Mercer Capital provides transaction advisory and financial advisory services to a broad range of public and private companies and financial institutions. Whether considering an acquisition, a sale, or simply planning for future growth, Mercer Capital has the experience required to help companies and financial institutions accomplish their financial objectives.

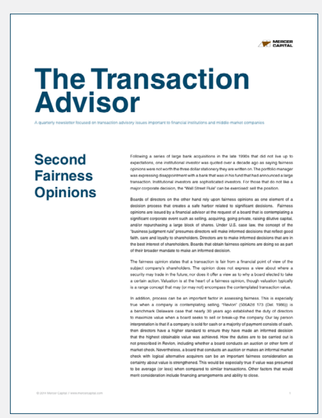
Financial Institutions		Public and Private Companies	
Jeff Davis, CFA Managing Director 615.345.0350 jeffdavis@mercercapital.com	**Andy Gibbs, CFA, CPA/ABV** Senior Vice President 901.322.9726 gibbsa@mercercapital.com	**Tim Lee, ASA** Managing Director 901.322.9740 leet@mercercapital.com	**Nick Heinz, ASA** Senior Vice President 901.685.2120 heinzn@mercercapital.com

Announcing Mercer Capital's Most Recent Quarterly Newsletter

The Transaction Advisor

This newsletter focuses on transaction advisory issues important to financial institutions and middle market companies. Readers of *The Transaction Advisor* include board members, management, trustees, and other fiduciaries. Subscribe today to receive this complimentary newsletter.

SUBSCRIBE



Transaction Advisory

Second Fairness Opinions

Given the increase in litigation and greater scrutiny on investment bankers' contingent pay when issuing a fairness opinion, many boards have hired a second (or third) financial advisor that was not involved in arranging, negotiating and/or financing a transaction to issue a fairness opinion. Doing so will not preclude litigation, but boards that hire an independent financial advisor are taking a step to ensure their actions meet the standards of care, loyalty and good faith that form the basis of the Business Judgment Rule. This article originally appeared in Mercer Capital's newsletter, *The Transaction Advisor*.

Following a series of large bank acquisitions in the late 1990s that did not live up to expectations, one institutional investor was quoted over a decade ago as saying fairness opinions were not worth the three dollar stationery they are written on. The portfolio manager was expressing disappointment with a bank that was in his fund that had announced a large transaction. Institutional investors are sophisticated investors. For those that do not like a major corporate decision, the "Wall Street Rule" can be exercised: sell the position.

Boards of directors on the other hand rely upon fairness opinions as one element of a decision process that creates a safe harbor related to significant decisions. Fairness opinions are issued by a financial advisor at the request of a board that is contemplating a significant corporate event such as selling, acquiring, going private, raising dilutive capital, and/or repurchasing a large block of shares. Under U.S. case law, the concept of the "business judgment rule" presumes directors will make informed decisions that reflect good faith, care and loyalty to shareholders. Directors are to make informed decisions that are in the best interest of shareholders. Boards that obtain fairness opinions are doing so as part of their broader mandate to make an informed decision.

The fairness opinion states that a transaction is fair from a financial point of view of the subject company's shareholders. The opinion does not express a view about where a security may trade in the future; nor does it offer a view as to why a board elected to take a certain action. Valuation is at the heart of a fairness opinion, though valuation typically is a range concept that may (or may not) encompass the contemplated transaction value.

In addition, process can be an important factor in assessing fairness. This is especially true when a company is contemplating selling. *Revlon* (506 A.2d 173 (Del. 1986)) is a benchmark Delaware case that nearly 30 years ago established the duty of directors to maximize value when a board seeks to sell or break-up the company. Our lay person interpretation is that if a company is sold for cash or a majority of payment consists of cash, then directors have a higher standard to ensure they have made an informed decision that the highest obtainable value was achieved. How the duties are to be carried out is not prescribed in *Revlon*, including whether a board conducts an auction or other form of market check. Nevertheless, a board that conducts an auction or makes an informal market check with logical alternative acquirers can be an important fairness consideration as certainty about value is strengthened. This would be especially true if value was presumed to be average (or less) when compared to similar transactions. Other factors that would merit consideration include financing arrangements and ability to close.

Alternatively, *Revlon* would not apply in a deal structured as a stock swap because shareholders would continue to own an interest in a corporation that seeks to maximize long-term value; however, different factors will be considered in the context of fairness, including the value of the subject company's shares relative to the value of the shares to be received. Factors to be weighed include growth prospects of the combined companies, potential synergies, dividend paying capacity, earnings and book value accretion (or dilution), relative value compared to peers, trading volume and the like. In effect, it depends because there is not one standard that defines fairness.

Fairness opinions are typically issued by investment bankers who arranged a transaction; however, because most of their fee is contingent upon the successful closing of a transaction, the lead banker's opinion has always had some taint even if the consensus is that a transaction is a good deal. In 2007, the Financial Industry Regulatory Authority ("FINRA") issued Rule 2290, which requires the issuer of a fairness opinion to disclose such conflicts.

It is probably not a coincidence that transparency that is promulgated by Rule 2290 has led to more litigation. The New York Times noted on March 8, 2013, that "once you've announced a deal, you are likely to get sued." Academics Matt Cain of the University of Notre Dame and Steven Davidoff of Ohio State University published research in February, 2013, that 59% of all takeovers announced during 2005-2012 over $100 million with an offer price of at least $5 per share involved litigation.

The statistics were telling about the state of the corporate world, including over 200 such transactions in 2006 and 2007 compared to 150 in 2010, 128 in 2011 and just 84 in 2012. Pre-crisis, approximately 40% of the announced mergers entailed litigation; since 2008 the litigation rate has exceeded 84% each year. The average complaints per transaction were five, and 50% involved multi-jurisdictions. The median attorney fees to settle when disclosed were $595 thousand in 2012, which was within the $528 thousand to $638 thousand median band since 2006. "Disclosure-only" settlements (i.e., adding disclosures about the transaction to the proxy statement) accounted for 88% of the settlements in 2012 vs. 12% for settlements that increased the consideration or reduced the termination fee. In 2005 and 2006, "disclosure-only" settlements were only 64% and 58%, respectively.

Given the increase in litigation and greater scrutiny on investment bankers' contingent pay when issuing a fairness opinion, many boards have hired a second (or third) financial advisor that was not involved in arranging, negotiating and/or financing a transaction to issue a fairness opinion. Doing so will not preclude litigation, but boards that hire an independent financial advisor are taking a step to ensure their actions meet the standards of care, loyalty and good faith that form the basis of the Business Judgment Rule.

Mercer Capital is an independent valuation and financial advisory firm. We render hundreds of valuation opinions each year and are regularly engaged by boards to evaluate significant transactions. As part of our financial advisory practice, we regularly issue fairness opinions on behalf of boards that are involved in transactions that span a range of purposes, though M&A is the most common. If your firm is contemplating or has initiated a significant transaction, we would be glad to discuss the matter in confidence.

Jeff K. Davis, CFA
jeffdavis@mercercapital.com

Mercer Capital News

Rajbhandary Promoted to Vice President of Mercer Capital

Mercer Capital is pleased to announce that Sujan Rajbhandary, CFA, has been promoted to the position of vice president.

Sujan joined Mercer Capital in 2006 and is a senior member of Mercer Capital's Financial Reporting Valuation Group.

The Financial Reporting Valuation Group provides fair value opinions and related advisory services to public companies, private companies, and alternative investment vehicles.

Valuation opinions prepared by Sujan pertain to business units, intangible assets, stock based compensation, and portfolio investments. Sujan holds the Chartered Financial Analyst (CFA) designation from the CFA Institute.

"Sujan's contribution to Mercer Capital's Financial Reporting Valuation practice has been substantial," commented Matt Crow, president of Mercer Capital. "He is a trusted colleague and we are delighted to recognize his significance to the firm with this promotion."

Sujan also leads Mercer Capital's Medical Device industry team.

Thompson Earns Accredited in Business Valuation Designation

Mercer Capital is pleased to announce that Treadwell (Tread) B. Thompson, CPA, has been awarded the Accredited in Business Valuation (ABV) designation from the American Institute of Certified Public Accountants.

The ABV credential recognizes those with professional experience and education in business valuation. Tread met the requirements to earn his ABV by providing evidence of experience and continuing education in business valuation and passing a written exam covering the business valuation professional and regulatory standards, valuation methods and analysis.

Tread is involved in the valuation of corporate entities, as well as the valuation of financial institutions, employee stock ownership plans, estate and gift tax planning, and compliance matters.

Upcoming Industry Events

The senior staff of Mercer Capital attends and presents at numerous industry and professional conferences. If you are attending as well, please let us know so we can connect with you.

American Animal Hospital Association 2014 Annual Conference

March 20 - 23, 2014
Nashville, TN

Nick Heinz, Senior Vice President, will be attending this event.

Nick Heinz » heinzn@mercercapital.com

NCEO 2014 Annual Conference

April 8 - 10, 2014
Atlanta, GA

Matt Crow, President, **Nick Heinz**, Senior Vice President, and **Andy Gibbs**, Senior Vice President will be attending this event.

Matt Crow » crowm@mercercapital.com
Nick Heinz » heinzn@mercercapital.com
Andy Gibbs » gibbsa@mercercapital.com

AICPA/AAML Conference on Divorce

April 24 - 25, 2014
Las Vegas, NV

Chris Mercer, CEO, will be speaking in three sessions. He will present a general session on April 24 on "The Five Really Big Issues in Business Valuation." In addition, he will participate on the following panel discussions: "The Great Debate on the Future of Marketability Discounts" and "Hot Debate on the Hot Topics in Business Valuation."

Chris Mercer » mercerc@mercercapital.com

37th Annual ESOP Association Conference

May 8 - 9, 2014
Washington, DC

Tim Lee, Managing Director, will be speaking at this event on May 9, 2014 on the topic of "When the Call or Letter Arrives – DOL/IRS Investigations."

Tim Lee » leet@mercercapital.com

Mercer Capital

Mercer Capital's ability to understand and determine the value of a company has been the cornerstone of the firm's services and its core expertise since its founding.

Mercer Capital is a national business valuation and financial advisory firm founded in 1982. We offer a broad range of valuation services, including corporate valuation, gift, estate, and income tax valuation, buy-sell agreement valuation, financial reporting valuation, ESOP and ERISA valuation services, and litigation and expert testimony consulting. In addition, Mercer Capital assists with transaction-related needs, including M&A advisory, fairness opinions, and strategic alternatives assessment.

We have provided thousands of valuation opinions for corporations of all sizes in a variety of industries. Our valuation opinions are well-reasoned and thoroughly documented, providing critical support for any potential engagement. Our work has been reviewed and accepted by the major agencies of the federal government charged with regulating business transactions, as well as the largest accounting and law firms in the nation on behalf of their clients.

Contact a Mercer Capital professional to discuss your needs in confidence.

Contact Us

Timothy R. Lee, ASA
901.322.9740
leet@mercercapital.com

Matthew R. Crow, CFA, ASA
901.685.2120
crowm@mercercapital.com

Travis W. Harms, CFA, CPA/ABV
901.322.9760
harmst@mercercapital.com

Nicholas J. Heinz, ASA
901.685.2120
heinzn@mercercapital.com

Z. Christopher Mercer, CFA, ASA, ABAR
901.685.2120
mercerc@mercercapital.com

Mercer Capital
5100 Poplar Avenue, Suite 2600
Memphis, Tennessee 38137
901.685.2120 (P)

www.mercercapital.com

VALUE MATTERS™. This newsletter, published 6 times per year, addresses gift & estate tax, ESOP, buy-sell agreement, and transaction advisory topics of interest to estate planners and other professional advisors to business. For other newsletters published by Mercer Capital, visit www.mercercapital.com.