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Issues & Updates

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Bombshell Property Tax Ruling Includes Unreasonable Compensation Issues

A nonprofit hospital in New Jersey has lost its property tax exemption over a number of different issues, including overly lavish compensation of its executives and improper deals with physicians. This case was being closely watched and could trigger similar actions from cash-strapped municipalities—as well as spark challenges to tax-exempt status from the feds.

Crossed the line: The New Jersey Tax Court ruled that the Morristown (N.J.) Medical Center is not entitled to a property tax exemption because its activities are so intermingled with for-profit doings that it no longer resembles a charitable institution. According to an alert from the American Health Lawyers Association (AHLA), a number of issues caused the hospital to cross the line, including having a corporate structure laced with for-profit subsidiaries, unreasonable compensation of executives, questionable contracts with for-profit physicians, improper incentive pay deals with employed physicians, and third-party agreements that were improper profit-sharing deals in disguise.

According to a report on NJ.com, Judge Bianco ruled that the hospital failed to establish the "reasonableness" of the salaries it paid to executives. He noted that the hospital's comparison of its executive salaries only to those of its peer group hospitals creates a "wholly self-serving" justification. The hospital's CEO was paid $5 million in 2005, including perks such as an automobile stipend, a cell phone plan, and a golf club membership.

As a result of the ruling, the hospital will have to pony up $2.5 million per year in property taxes for the years at issue (2006 to 2008). There is no word on whether the hospital will appeal.

Watch out: Nonprofit entities everywhere have been watching this case, according to the AHLA alert. Of course, this ruling only concerns the organization's state property tax exemption and does not affect its tax-exempt status under federal law. If, however, other courts adopt the reasoning of the New Jersey Tax Court, the door may be open to nonprofit status challenges, with the potential loss of tax-exempt status.

The New Jersey case is *AHS Hospital Corp. d/b/a Morristown Memorial Hospital v. Town of Morristown,* Docket Nos. 010900-2007, 010901-2007, and 000406-2008.

Study Reveals a Shift in Approach to Valuing Synergy

The M&A valuation practices of investment banks have undergone a notable shift in recent years with respect to synergies and strategic opportunities, according to a study published in the Journal of Applied Finance.

More scrutiny: All but one of the 11 major investment banks interviewed say they take specific steps to deal with synergies rather than just folding them into the company's cash flows and discounting all at the same rate. In a similar study done in 1998, only half of the advisors said they made special adjustments to value synergies differently. The authors of the study believe that this trend is due to the increased recognition that planned synergies often don't pan out.

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The purpose of the study was to examine how leading practitioners apply discounted cash flow (DCF) techniques to value companies in an M&A context. The authors found that the application of DCF is far from "routine" and a complex set of judgments is used. The authors write: "Our results serve as yet another reminder that analytic techniques such as DCF do not make decisions but only inform them."

How an Audit Committee Investigates Fair Value Estimates

PwC has issued a paper describing the role of the audit committee in scrutinizing fair value in the context of its oversight of financial reporting. Because of the complexity and subjectivity of fair value estimates, the audit committee can ask questions regarding the valuation process for assets of material value.

Probing questions: One question the audit committee may ask is whether a third-party valuation specialist was used for fair value estimates. If so, how was the valuator chosen and what are his or her qualifications? The committee can also ask about the process and controls related to the valuations. What valuation models were used? What were the key assumptions?

The regulators (SEC and PCAOB) have made it clear that fair value estimates are an important part of a company's financial statements and management must develop and maintain internal controls with respect to these valuations.

Trade Secret Valuation Paradox

One of the reasons a trade secret has value is because it is secret — only a limited number of people have access to it. If a trade secret is stolen, litigation can be triggered. But the trade secret can be disclosed during the litigation, so doesn't the existence of the litigation itself impact the valuation? It could, but the parties involved are aware of this phenomenon.

Under wraps: A number of different precautions are used to prevent the disclosure of the trade secret during litigation. For example, a protective order can limit access to the information to just the attorneys. Also, the information can be submitted to the court "under seal," and the court, after looking at it, can redact the sensitive information before releasing it to the public.

Most of the time, valuators are dealing with trade secrets in a litigation context, so valuation tools are being used to calculate economic damages. In general, this is designed to put the parties in the position they would have been in "but for" the alleged wrongful act.

What to do: In a valuation engagement involving a trade secret, the analyst should investigate any prior litigation to see whether any disclosures could have increased the risk of impairment.

A bipartisan group of leaders in the U.S. Senate and House of Representatives has introduced a bill that would protect valuable intellectual property and close a loophole in U.S. law by creating the first federal private right of action for the theft of trade secrets. The Defend Trade Secrets Act is aimed at preventing hundreds of billions of dollars in losses every year in the U.S. due to theft of corporate trade secrets.

Chancery Blasts Expert Over Manipulated Valuation

In re El Paso Pipeline Partners, L.P. Derivative Litigation, 2015 Del. Ch. LEXIS 116 (April 20, 2015)

The judges on the Delaware Court of Chancery are known for their sharp intellect and, sometimes, sharp tongues. Still, a recent decision stands out for the court's stinging rebuke of a financial firm that enabled a series of problematic transactions.

Dropping assets: In spring and fall 2010, a parent entity off-loaded interests in two subsidiaries to a master limited partnership (MLP) that it controlled through ownership of a company that served as the MLP's sole general partner. The MLP was organized as a pass-through entity. The transactions were acquisitions in which ownership interests "dropped down" from the parent to the MLP such that the parent could reap the tax benefit and obtain capital at the lowest possible cost. The subsidiaries owned a liquefied natural gas (LNG) import terminal and a natural gas pipeline. By 2010, there was decreasing demand for LNG imports, which had the parent company worried about the stability of long-term service contracts one subsidiary had with Shell and British Gas.

The dropdowns prompted several lawsuits in which the MLP's common unit holders alleged the MLP paid inflated prices for the assets. Also, members of the special committee that had to approve the transactions breached the governing partnership agreement that required them to believe in good faith that the dropdowns were in the best interests of the MLP. The Chancery dismissed the claims related to the spring dropdown but allowed the fall dropdown claims to be tried. Subsequently the court said it expected that at trial the committee members and their financial advisor would provide a credible account of how they evaluated the fall dropdown. Instead, it found they "had no explanation for what they did." The committee members "went against their better judgment and did what parent wanted, assisted by a financial advisor that presented each dropdown in the best possible light, regardless of whether the depictions conflicted with the advisor's work on similar transactions or made sense as a matter of valuation theory."

Eyes on fees: The financial advisor did none of the "real work" an advisor to a committee does, the court said. The advisor's "real client was the deal, and the firm did what it could to justify the fall dropdown, get to closing, and collect its contingent fee."

The Chancery found instances of "nonfeasance" and "malfeasance." When the committee asked the financial advisor to assess the parent's proposed fall dropdown in light of the weakening LNG market, the advisor went to the parent for feedback. Not surprisingly, the parent replied that the situation was stable and the assets were solid. The financial advisor also manipulated valuation methodologies to make the parent's asking price more palatable, the court said. While a financial advisor need not treat every transaction in the same way, "it would be surprising if every one of the changes moved the analysis in the same direction." This happened here. The general partner breached the agreement and caused $171 million in damages, the court decided.

Takeaway: The overpayment was made possible because the financial advisor abdicated its responsibility to the special committee, whose members in turn subordinated their independent views to the parent's wishes, the Chancery concluded.

20 Questions to Ask When Valuing Intellectual Property

Intellectual property ("IP") and intangible assets now make up close to 80% of the total market capitalization of the S&P 500 (up from less than 20% in 1975). They can also be an important component of private-company value and could be a big part of an individual's wealth, particularly for authors and artists.

There is a difference between intellectual property and intangible assets. Intangible asset is an identifiable, nonmonetary asset without physical substance, such as accounts receivable. However, intellectual property is really a subset of intangible assets that has legal protection (legislation and/or case law) and remedies for violations. There are four types of intellectual property ("IP"): patents, trademarks, copyrights, and trade secrets.

An article in the December 2015 issue of Mergers & Acquisitions discusses the impact that IP can have on a merger or acquisition. For instances in which the IP is the driving force for the transaction, the importance and need for adequate due diligence on the IP becomes even more important. From a buyer's perspective, there are obvious needs in analyzing assets (ownership, current status, intended use), as well as underlying factors (i.e. foreign protection). Each of these can have a material effect on a negotiation and valuation, and a buyer should seek to uncover all identifiable factors before acquisition to understand exactly what it is buying. Presented below is a checklist of some of the questions to ask as part of the IP due diligence.

1. Who owns the IP? The ownership of the IP is one, if not the most, important factor. A clean chain of title from the inventors to the target company must be present. Any question of a loss of ownership in the chain can affect the price since ownership is not clear.

2. If an entity, who controls the rights? The entity itself may not control the rights—they could have been assigned to a third party.

3. *Are there restrictions on the IP?*

4. Are rights assignable by the owner? You need to know whether it's been assigned and who all the parties are who have any rights.

5. Has the IP been published, patented, or registered? IP without protection can be vulnerable, so this adds an element of risk.

6. Are royalties being paid? If little or no royalties are being paid, maybe it's not a valuable property.

7. If royalties are being paid, what are the terms of the deal? Get a copy of the contract.

8. What has been the trend in the level royalties over the last five years? Decling royalties may equate to a limited life of the IP.

9. Are additional efforts required to continue the revenue stream? For example, personal appearances, seminars, and so on may need to be done to keep the money flowing.

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10. Has there been a lump-sum advanced payment, requiring additional work on the part of the author/artist? Maybe the work doesn't pan out, so the creator or contractor (publisher or producer) may abandon the project.

11. Is the future income stream fixed or variable and where does it come from?

12. What development costs are needed to optimize revenue? The individual or entity may not be willing to foot the bill for these costs.

13. When do rights end? Rights don't last forever, and the duration depends on the nature of the property.

14. If a patent, is there a risk of the patent being declared invalid? Maybe the creator infringed on another patent. Also, just because an IP asset with broad claims is allowed by an examiner and issued by a patent office does not mean it will survive a contention of invalidity brought by a defendant or other third party. An in-depth prior art search should be conducted against an IP asset.

15. Have all of the marketing efforts necessary to maximize revenues been completed, started, or planned? If not, find out who will carry these activities out—and whether it will happen at all.

16. Has the owner issued any licenses? If yes, what are the terms and duration of the licenses. The existing licensing program of a target company can significantly impact value. For example, if a target company directly licenses IP assets to a competitor of the acquiring entity, then these encumbrances on the IP may make them worthless to acquire.

17. Are there other licenses that could be obtained to generate revenue? The potential for additional licensing opportunities will affect potential income streams.

18. Are there derivative works? A derivative work is a separate work that stems from the original, such as a movie made from a book.

19. May existing rights be divided (in kind) without infringing on the interest?

20. How are the revenues and expenses tracked and reported?

ABOUT VALUE MANAGEMENT INC. VMI is a financial consultuing firm specializing in valuing and selling businesses, corporations and professional practices. Our firm is bulilt on the performance of more than 6,500 valuations. Appraisals are rendered for estate tax planning, litigation support, and many other situations requiring independent appraisal. Our newsletter is published quarterly and does not constitute legal or financial consulting advice. It is offered as an information service to **VMI**'s clients and friends. Those interested in specific guidance for legal and accounting matters should seek competent professional advice. Inquiries on specific transaction matters are welcomed.

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