Winter 2015 Newsletter

Firm Values

A Business Appraisal Publication

Presented By:

Happy holidays to you! We offer this newsletter to provide insight into current information and trends in business and the appraisal industry. We hope you find it enriching and welcome any questions or comments you may have.

For more information about our practice please visit our website at GRWAppraisalServices.com or call us at 512-574-3444. Enjoy!

Greg Weichbrodt - Principal

Chancery savages accounting firm over manipulated valuation

This ruling is just the latest decision in which the Chancery Court has awarded damages and/or ordered injunctive relief based in part on a financial firm's failure to discharge its role

appropriately. Calling the valuation firm's work "a new low".

The Delaware Court of Chancery has on numerous occasions called out major financial institutions for providing erroneous or even "motivated" valuations. But few opinions include more searing criticism than a recent decision from Vice Chancellor Laster, in which he said a major accounting firm's work on a spin/merge transaction "reached a new low."

Zero-tax goal: A healthcare company tried to raise money to keep two promising but not yet profitable business units funded and generate revenue for its stockholders by spinning off the two entities and merging the remainder of the company with the acquirer. The goal was to avoid a corporate tax liability for the company's controlling shareholders. For this purpose, top management hired accounting firm 1 to produce IRS-driven valuations. Firm 1, using manipulated projections the company provided, produced a transfer tax valuation that said the first spinoff was worth about $47 million and the second about $15 million. In a different context, management had said one unit was worth about $150 million to $300 million and had expressed optimism that the other unit in time would generate a lot of money.

Uncomfortable with the valuation, the buyer insisted on a second, "independent," valuation from a different accounting firm. Firm 2 regularly had prepared stock option-related valuations for the seller, using a combination of discounted cash flow analysis and comparable company analyses. Despite different valuation dates, the inputs were generally consistent and so were the results. Also, all the valuation determinations consistently showed that the two separated entities contributed at least a third of the company's total value. In contrast, the spinoff values firm 2 generated were so low that they only represented 7% of the combined enterprise value for the company in relation to the $725 million deal price.

Employees, who owned about 3% of the company in the form of stock options, sued, claiming that management, driven by tax considerations, had intentionally, and to the detriment of the option holders, undervalued the separated entities.

Copy job: The court agreed. "The option holders were collateral damage," the court said. Even if the company probably did not want to harm its employees, once management had devised a plan to achieve a zero-tax outcome for the controlling stockholders, it was willing to sacrifice the employees' interests.

The court called the valuation determination underlying the option price "arbitrary and capricious." The report firm 2 produced was an example of action "so egregiously unreasonable as to be essentially inexplicable on any ground other than subjective bad faith," the court said. It noted that the firm's past work showed that it was capable of valuing the two separated entities as going concerns. But for the spinoff the firm abandoned its rigor and methodology. The firm's employees viewed their task as "just copying [firm 1's] report and calling it our own," which is what they did, the court said. "The copy job was so blatant that the output matched [firm 1's] even when the inputs differed." When firm 2 did its own work, it made "fatal errors, such as using the materially lower figure for nine-month trailing revenue rather than twelve-month projected revenue," the court pointed out. At trial, the

defendants "wisely" tried to distance themselves from firm 2's valuation by saying no one relied on it.

The court determined that damage to the option holders amounted to over $16.26 million.

Takeaway: In trying to understand what motivated the participants in this "transgression," the court said that humans cross lines when the transgression can be rationalized, the benefits seem immediate, and the potential costs seem distant considering the slim chance of detection and the possibility of a successful defense or settlement. But, as this case illustrates, bad deeds do get uncovered and the cost to reputation may be high.

Find an extended discussion of Fox v. Cdx Holdings, 2015 Del. Ch. LEXIS 194 (July 28, 2015),

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Trademark values of real estate websites

Presented below is a summary of data collected by Markables, an online consolidator of trademark valuations from published financial reportings. In the table, they summarize the value of trademarks specific to websites that contain advertisements for renting or selling real estate, an industry that continues to show expansion.

Using this type of website, the property owner lists and pays for the ad, but the service is free for the potential buyer or tenant. Typically, the online service does not enable direct transaction between seller and buyer. As these are mostly pay-per-use services as opposed to subscription-based, the brand is an important value driver of these businesses. The peer group includes 14 cases between 2006 and 2014 from seven countries, including apartment.com and LoopNet.com. The analysis suggests a 10% median royalty rate for a company brand and a 20% share of total company enterprise value. Only four of the 14 brands have been assigned a finite life, which is a small percentage compared to other online businesses.

MARKABLES®

Trademark Values - Peer Group Analysis			07/2015
Online classifieds – real estate (including listings for sale and for rent)			
no. of observations: 14 period: 2006-2014 countries: 7	Trademark royalty rate	Trademark profit split	Enterprise value
	% of revenues	trademark value in % of enterprise value	revenue multiple
25% quartile	7.3%	8.0%	2.55x
median	9.8%	20.3%	4.67x
75% quartile	14.2%	27.3%	7.08x
mean	12.1%	18.7%	5.55x
Trademark life	indefinite life: 71% definite life: 29% with average useful live of 6.5 years		
Trademark revenues	from USD 1 million to USD 145 million		

Source: www.markables.net

Tax exempt companies may be at risk based on recent property tax ruling

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 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 email 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).

Watch out: "Nonprofit entities everywhere" have been watching this case, according to attorney Rebecca M. Waddell (Hall, Render, Killian, Heath & Lyman PC), who wrote 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 cherished tax-exempt status," says Waddell.

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.

IRS assault on valuation discounts for FLPs is looming

In recent months, one persistent rumor has circulated in the blogosphere dedicated to estate and gift tax issues. It's that the IRS is about to eliminate or at least limit the application of discounts related to family limited partnerships and similar structures. Also, a recent article in The New York Times discusses the impending crackdown.

Popular tool: FLPs and their variants are a popular tool to shift significant family wealth from one generation to the next at greatly discounted value. Under a common scenario, the transferor contributes assets to an FLP and then assigns fractional limited partnership interests to the transferees. Provisions in the partnership agreement or the organizational structure may place restrictions on the fractional ownership interest, as far as concerns control, marketability and liquidity, and transferability. If the restrictions stand up to scrutiny, they can translate into significant discounts and gift and estate tax savings.

The IRS has long been concerned over depressed valuations but has had limited success litigating the issue. Recently, representatives from the IRS and the U.S. Treasury said that new regulations limiting the use of valuation discounts would be forthcoming. It's not clear when this will be or how the language will read.

Relevant law: In 1990, Congress enacted Chapter 14 of the Internal Revenue Code, particularly sections 2703 and 2704, to prevent perceived abuses of the system. Section 2704(b), which deals with restrictions affecting the ability of a partnership or corporation to liquidate, is likely to be the focal point of the threatened regulations. It says that, if there is a transfer of an interest in a corporation or partnership to a member of the transferor's family, and immediately before the transfer the transferor and his family have control of the entity, any "applicable restrictions" are disregarded when determining the value of the transferred interest.

In a 2001 technical advice memorandum (FSA 200143004), which discusses sections 2703

and 2704, the IRS's office of chief counsel explains how the agency may deploy the provisions in a gift tax matter. A digest of FSA 200143004 and the full text of the TAM are available at BVLaw. More on this issue is sure to follow.

AICPA issues new practice aid on economic damages

Reasonable Certainty in Economic Damages Calculations is now available from the AICPA, according to the August 5 edition of the AICPA's FVS News. "The objective of this practice aid is to expand upon existing literature and raise awareness concerning those aspects of a damages calculation in which the concept of reasonable certainty is most likely to be scrutinized," says the AICPA. The practice aid covers client-supplied information, causation considerations, and newly established businesses. In terms of newly established businesses, there is an extensive analysis of factors considered by courts to establish the reliability of benchmark data.

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