T&E Alert August 15, 2014

Matter of Adelstein v. Finest Food Distributing Co. N.Y., Inc. New York Appellate Division: 2nd Judicial Dep't. [dissenting shareholders' statutes under NYS Corporation Law § 1118.]

Two brothers started a business distributing pickles in 1948. A third brother joined the business, which eventually became the largest distributor of Caribbean specialty foods in the New York, New Jersey and Connecticut area, selling to most supermarkets. By 2006, two shareholders had gifted their interests to their sons, and the third had refused their offer to buy him out. Eventually, he sued under the dissenting shareholders' statute. The trial court - called a Supreme Court in New York - refused to dismiss his petition. At that time, the Company elected to buy the plaintiff out under the statute and the court held a valuation hearing in 2011. The decision of the Supreme Court illustrates well how judges in New York assess the work product of business appraisers before rendering judgement. In April, 2014, the appeals court simply affirmed.

The CPA hired by Finest Foods did not have any valuation credentials, and based his opinion on a review of corporate tax returns and conversations with the principals. He used a capitalization of income method after normalizing salaries and depreciation and weighted recent results more heavily than older ones. He determined the capitalization at 20% after considering the fact that perhaps 20% of revenues were with A&P, a chain in bankruptcy. He observed that while revenues had doubled in the 6 years up to 2010, net income had not. His report was all of 3 pages.

The plaintiff's appraiser holds several appraisal designations and performed a good deal more work. He visited the premises and reviewed the books and records, including the general ledger, bank statements, and available delivery truck manifests and salesmen' records. His conversations with the principals also revealed that, while large supermarket chains pay by check from a central office, small retailers, including many "bodegas" pay the Company's driver in cash at delivery. That cash appears not to have been recorded on the books, except on salesmen's manifests. During the period under study, sales doubled but margins decreased to less than the industry average, while insider salaries increased. To the appraiser, this suggested unreported sales, which he proved by performing a forensic stress test on invoices. He estimated that unreported sales amounted to another 10% of recorded sales, and that the gross margin was equal to the industry average of 35%, not the 25% reported on the tax returns. Using a 12% capitalization rate, he determined that the controlling, marketable value was $4.0-$4.1 million.

As a cross-check, he also used a market-based approach, the merged and acquired company method, which yielded similar values. He applied a 5% lack-of-marketability discount, reasoning that the sale of such small business would incur relatively low transaction costs. He also respected the New York statute by applying an LOMD, but not a minority discount. The court sang his praises and the appeals court did as well. The decision can be found at http://NYNJCT-BV.com/Adelstein.pdf

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