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Matter of Abraham [Elite Technology NY, Inc.] 2010 slip Opinion 33225 in Supreme Court New York County 11/10/2010 commercial division

Elite Technology is a New York corporation started in 1993 by 2 businessmen to distribute office machines; in 2003, the corporation admitted 2 new shareholders with a combined stake of 49%. The new shareholders expanded the sales capability of Elite Technology by hiring and training salesmen. As a result, the company grew from one to 3 locations and from few salesman to a sales force of 26; sales tripled. In 2006 however, the 2 groups of shareholders had a fall-out, and the Company fired the new shareholders as sales managers, claiming that the latter had neglected their duties. The fired shareholders jointly filed a petition for judicial dissolution of Elite under the NYS Business Corporation Law, section 1104-1, alleging minority shareholder oppression. The minority shareholders alleged that they were excluded from corporate governance, while majority owners wasted and depleted Elite's assets. The majority replied by electing to purchase the petitioners' shares for fair value under BCL section 1118.

The issue of valuation was referred by the Court to a referee, who held 4 days of hearings during which both sides' experts testified. The referee rejected the respondents ' calculation which had increased its discount rate by 6% for key man considerations because the departing shareholders could not be deemed to be key persons; they had being brought in as sales managers and built a trained sales force; after that was accomplished, the new shareholders could no longer be deemed key to Elite; in fact they were replaced within the year of their dismissal as sales continued to climb. On the other hand, the referee decided that normalized earnings were much closer to the petitioners' expert data of $1 million than the respondents' $246,000. Normalization was performed by the petitioners based on data published by Robert Half International, a staffing firm. The respondents made small normalization adjustments, but tax effected earnings, while the petitioners did not. The petitioners used 2004-5 data, corresponding to the period before the firing, while the respondents used 2006 only. Capitalization rates used by the experts were not exactly comparable: the petitioners' rate was 18.8% less 7% for growth, while the respondents used 25% [see above] less 4% growth. The lack-of-marketability discounts were 25% and 19%, respectively. In the final analysis, the referee concluded that the value of the petitioners' stake was $3.2 million, or 6 times the amount calculated by the respondents primarily because of the normalization. The Court agreed with all recommendations of the referee, and gave the respondent one year to pay.

The Court decision and the referee's report can be found at http://nycourts.gov/ecourts enter the index number 602895/2006; then click on Show Decisions. The referee's report is also available at http://www.NYNJCT-BV.com/EliteReportFV.pdf. Please do not hesitate to call or e-mail to discuss this or any other business valuation issue.

Reis v. Hazelett Strip-Casting Corp. DE Chancery Court opinion decided January 21, 2011 [Shareholders'dispute, Fair Value, DE minority anti-oppression statutes.]

Hazelett, founded in 1929, manufactures large strip-casting machines which sell for $16 million apiece and are used in heavy manufacturing operations; since each of its machines has a long economic life, the Company sells few machines annually, and relies on spare parts and the servicing of existing equipment for day-to-day revenues. The founder's 2 sons owned unequal stakes, the elder with 70%, the younger with 30%. When the younger brother died in 2002, he willed his shares to 162 people, mostly employees and former employees of the Company. This did not sit well with his older brother, who was intent on running the Company as a family-owned business as his father before him. In order to retain control, the older brother offered the estate $1,500 per share, a number he admittedly was not supported by appraisal or any other analysis, reflecting his distaste for non-family shareholders. In 2005, the board, itself under the control of the elder brother, voted to effect a reverse stock split. An appraiser was engaged, who opined that the fair value per share was $1,600. The board amended the Company's charter to complete the transaction, but failed to file the amendment until January, 2008. The reverse stock split was challenged in Delaware Court by the beneficiaries of the younger brother's will, alleging that the board had breached its fiduciary responsibility to the minority holders by not paying "fair value." Eventually, the Court decided that the effective date of the reverse split was January 2008.

The Court stated that the whole process had not been fair and that the "entire fairness standard" would apply, in addition to shifting the burden of proof to the defendant. Under Delaware law, there are three available standards: "business judgement rule", "enhanced scrutiny" and "entire fairness standard." That the highest standard was deemed appropriate in a reverse split without any procedural protection constitutes a precedent which is protective of minority owners.

The board engaged the earlier appraisal firm to update its opinion; it came in lower at $1,500; the plaintiffs, on the other hand, had commissioned an appraisal showing a value per share of $5,490. The plaintiffs had used a guideline public company approach, but comparable firms were substantially larger than Hazelett and the Court termed the approach "meaningless." The Court also rejected a capitalization of free cash flow because it required too many normalizing adjustments and only 2 years' results had been used to justify a "projection." In the eyes of the Court, capitalizing earnings was the most appropriate method, least of which because it was used as part of the "Delaware block" methodology - more on that later.

The defendant's appraiser had made no adjustment to the historical record and projected data was simply not available. The plaintiifs's appraiser had made adjustments, but some were deemed inconsistent with Delaware law. Accordingly, the court used the defendants' report as a starting point, making the following adjustments.

R&D costs: research expenses at the Company have historically copied the industry average; during the down-turn of 2007, however, the Company used the credit to pay salaries of furloughed employees, consistent with its policy not to layoff employees in down cycles. The plaintiffs' appraiser had added the cost to earnings; the court disagreed and reversed the credit, reasoning that only a control owner can make that change.

The Company incurred a number of costs under the general heading of management perks. While the plaintiff's appraisal report never termed management's compensation as either "at market" or not, the adjustments were approved by the Court.

Non-recurring sales of fixed assets and real estate were also deemed necessary adjustments.

The Court also adjusted the tax rate to a more "normal" 47%.

The discount rates of both experts, resulting from the application of the add-on method, also required adjustment by the Court: the plaintiffs used 18% and the defendant 21%. Because of what the Court called the "inherent danger" of overestimating the company-specific risk premium, and because it was not entirely convinced that calculated earnings reflected the economic substance of the Company, it dramatically reduced the company-specific premium to

2%, which was the plaintiff's. Thus the Court determined the discount rate at 17%.

The defendant's expert had estimated long term growth at 4.4% after a conversation with management. The plaintiffs had pegged growth at 4%. "Because the defendants' expert had better access to operations ..and more incentive to be conservative," the Court calculated the capitalization rate by subtracting the higher growth, resulting in a capitalization rate of 11.6%.

Capitalizing the six year weight-averaged earnings base by the capitalization rate returns $2.44 million, to which the Court added non-operating assets without deducting selling expenses. The Court did not add research and other tax credit simply because the plaintiffs' expert "did not ask for it." It also refused to allow a credit for the moneys already paid the plaintiff during the reverse split because the money had been paid out of a line of credit, not from Company cash. The Court indicated that it would have adjusted for the cost of that borrowing, but that the plaintiff's expert did not provide the information. The Court's calculation thus stood, at this point, at the equivalent of $3,175 per share.

The Court was still troubled by the fact that the Company's book value was $7.7 million or roughly twice the value calculated by the Court. Without providing any detail, the Court reasoned that management's "self-dealing" had been responsible for the discrepancy. In order to compensate for the perceived wrong, it weighted the above value 80% and the book value 20% and ordered the fair value to be $3,845 per share, or 2.4 times what the Company had paid.

In retrospect, the Court's reasoning is based on the composite "Delaware Block" method, which was the rule before Weinberger in 1983. For a capital intensive business with volatile earnings, tight family control and a balance sheet reminiscent of a family holding company, perhaps justice was done to the minority owners in this manner. The Court decision can be found at http://courts.delaware.gov/opinions/download.aspx?ID=149590 then download the file reis.pdf. The decision is also available at http://www.NYNJCT-BV.com/reisDE.pdf. Please do not hesitate to call or e-mail to discuss this or any other business valuation issue.
Fair Value - Alert May 11, 2011

Matter of Giaimo [EGA Associates, Inc.] 2011 NY Slip Opinion 50714U in Supreme Court NY County April 25, 2011 and Report & Recommendation by Special Referee Louis Crespo dated June 30, 2010 [Shareholders' dispute, Fair Value, NYS anti-oppression and judicial Dissolution/re-purchase statutes, Real Estate Holdings.]

This Fair Value decision under NYBCL §1118 [the NYS law which defines the right of oppressed shareholders to obtain payment for their shares] covers two real estate holding entities structured as regular, non-passthrough corporations almost equally owned by two feuding siblings. The two entities own a number of walk-up apartment buildings and a development site in NY City. Valuing the two corporations under the fair value statutes is first a matter of valuing the underlying real properties, then making appropriate adjustments to value the stock of the two corporations. The Special Referee's report has a total of 181 pages and first devotes 80 pages to the work products and testimonies of several real estate appraisers. The report is a must-read for all appraisers. The referee's conclusion was that the corporations owned real property worth $26.6 million, cash and other assets of $6.9 million, offset by liabilities of $1.4 million. Not being a real estate appraiser, my comments will be limited to the valuation of the two corporations.

The report carefully considers applying a Lack-of-Marketability ["LOMD"] discount, an adjustment for Built-In Capital Gains ["BIG"] tax, and a "discounted" portion of the BIG tax adjustment. The Court generally followed the recommendation of the Special Referee, and, in the end, disallowed any LOMD because it appeared to be double counting and conflicted with appellate decisions. Despite the explanation of a noted business appraiser/author who testified, the Court disagreed with the referee's reasons for not requiring an LOMD. The main reason for excluding the LOMD is that fair value is based on control, and that a control owner can sell the underlying properties in the market.

The Court also authorized a reduction in value equal to the present value of the built-in capital gains or BIG tax, following the computation sanctioned by the NYS appeals court decision Murphy v. U.S. Dredging Corp [74 AD3rd 815, 2nd department] of June 1,2010. The BIG discount is an unavoidable issue for C corporations which own appreciated assets, and the complexity of the two corporations' portfolios of rental properties suggest that even partial liquidation would take time, hence the discounted BIG discount model makes sense. The Court used 3% growth over a ten year period, resulting in a deduction equal to 45.9% of the BIG tax. The Court also gave the corporations six months to pay for the shares.

The referee's report is available at: http://www.NYNJCT-BV.com/GiaimoRefereeRptNYFV.pdf. Please do not hesitate to call or e-mail to discuss this or any other business valuation issue.

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