Fall 2014 Newsletter

Matter of Adelstein v. Finest Food Distributing Co. N.Y., Inc.
New York Appellate Division: 2nd Judicial Department.
[dissenting shareholders' rights 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. In 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 the 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.

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 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 the 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 the merged and acquired company method, a market approach, 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 not applying a discount for minority. The court sang his praises and the appeals court, which simply affirmed in 2014, did as well. The 2011 decision is at http://NYNJCT-BV.COM/Adelstein.pdf

A Guide to NYNJCT-BV.COM

Yes, even our website now needs a guide/map, and this notice is intended to help readers find case law which we have written about [as always from the perspective of a business appraiser practitioner, not as a lawyer.] It should not surprise that a guide is now required, since the website has been available since 1998 [4 issues for 16 years equals 64 newsletters.] This practice's first newsletter was issued in September, 1998 and Case Alerts [mostly T&E Alerts] have been published since November, 2003 whenever an important decision is released.

If you are shopping for business valuation-oriented case law which we commented upon, the first place to review is http://www.NYNJCT-BV.COM/newsltr3.htm [click on "Our Quarterly BV Newsletter Archives are here!" in the middle of the first page of the web site - after the list of specialized services.] The page lists the topics of each issue or Keywords.

Just below the above is the following link: http://NYNJCT-BV.com/T&E_Alerts.htm [click on "Case Alerts: Valuation Related Court Decisions, Proposed Regs. & Fair Value"] The page lists approx. 46 cases and include U.S. Tax Court cases, appraisal rights cases in several jurisdictions, Delaware Chancery decisions, and several other pertinent decisions with BV considerations. In most cases, the Court's decision is available as well as our discussion thereof.

Estate of Adell v. Commissioner, T.C. Memo 2014-155 filed August 4, 2014

Like all court decisions, this case covers the specific facts and circumstances of a particular tax payer and its controversy with the IRS. As such, reference to a case should not be made in order to make a point with the Service because one's facts and circumstances are likely to be different. This is particularly true in this matter since the type of business involved is most unusual.

The Estate owned a 100% interest in STN, a cable up-linking company. STN was founded by the decedent and his son. "The World Network" is a 24 hour religious programming station which STN agreed to up-link, i.e. make available to thousands of people who can watch and participate. In order to make the arrangement, the decedent's son obtained the support of key religious leaders and DirectTV® became interested. The latter required a not-for-profit organization as a partner, and an IRC section 503-C organization was created with Adell as president and his son as treasurer, secretary and director. While that organization was not-for profit, 95% of the revenues from The World went straight to STN, a for-profit entity pursuant to the terms of a Service and Facilities Agreement. STN provides the services necessary to run all operations of The World under that agreement. It provides that The World pays STN a fee equal to the lesser of actual costs or 95% of net programming revenues received by The World. STN acquired equipment and personnel to fulfil its mission, but its largest expense consists of Mr. Adell and his son's compensation, which were higher than market.

The Estate's first valuation report, filed with the estate return, concluded with a $9.3 million value based on a discounted cash flow assuming that STN would receive 95% of The World's revenues. Adjustments were made for principals' salaries, a charge to reflect the son's personal goodwill, given his relationship with The World's directors and considering that he was not bound to any non-compete limitation. The discount rate was established by adding 3% to reflect the specific company risks, including the fact that STN only has one client. The discount rate aggregated 20%. In the meantime, the Service's appraiser had concluded that the value of STN was $92 million!

Four years after the date of death, the Estate had the same appraiser use book value adjusted to reflect the actual value of the equipment for a value conclusion of $4.3 million. He argued that limiting STN revenues to the lesser of 95% of revenues *or* actual costs makes it impossible for STN to generate any profits and that its value by the income method was thus nil; he accordingly relied on net asset value instead. The appraiser admitted to not understanding the agreement with The World.

The parties were thus very far apart, but the Court, after a thorough review of the appraisal work, looked at the actual record of STN profitability, suspecting that it suited both parties to not follow their agreement literally. The Court concluded that the Estate's original appraisal was the most reasonable, rejecting the Service's and any effort to use the net asset approach. The Court also called the Estate's first valuation "an admission." Given the Court's decision finding for the taxpayer, this should considered an Estate victory despite the fact that it changed its mind during trial [the Service also changed its valuation.] Why the appraiser changed his mind is difficult to understand. Perhaps the old adage of "getting it right the first time" has merit after all. Finally, the Court without comment allowed for a 20% discount for lack-of-marketability for a 100% interest. The decision can be found at http://www.NYNJCT-BV.COM/EstateofAdellMemo.Paris.TCM.WPD.pdf

Roll-Rite, LLC v. Shur-Co, LLC U.S. District Court for Eastern Michigan Bay City, MI filed May 29, 2014 [Lost profits from patented technology]

This recent decision constitutes an excellent primer of how to establish lost profits using the 4 factors Panduit test, itself named after *Panduit Corp. v. Stahlin Brothers Fibre Works 575 F2d 1152, 1156 [6th Circuit 1978.]* The plaintiff owned a patent for the use of a spur gear motor in an electric tarp spool system used for open top vehicles such as dump trucks. The plaintiff began selling the motors to the defendant, who incorporated them in its tarp systems for trucks. The defendant began experiencing problems with the motors and soon hired another firm to design and build a similar motor for use in its systems. In 2012, the plaintiff had lost that business and sued, claiming patent infringement and demanding lost profits.

The plaintiff expert used the 4 factors to reconstruct the market as it would have developed absent the defendant's new product. Since he did not receive the defendant's sales statistics, he calculated lost profits on a per unit basis and reserved the right to update his analysis. He found that lost profits for 2012 and 2013 ranged from $152 to $167 per unit. The incremental profit is the difference between lost revenues and additional costs that Roll-Rite would have incurred to generate those sales. His calculations took into account material costs, labor costs, variable overhead, warranty, freight, working capital and utility costs.

The defendant tried to exclude the testimony on the basis of both *Daubert* and the correct application of the Panduit factors. The Court disagreed and, instead, ruled that the Panduit factors had been met by the plaintiff's expert.

Factor 1: Did the patent holder establish demand for the patented product? The plaintiff cited historical sales, while the defendant introduced the notion of other favorable characteristics which may have sold his new product. The judge ruled this as irrelevant.

Factor 2: Was there an absence of non-infringing alternatives? The plaintiff explained that there were no alternatives and that thus his patent entitled him to all his profits calculated based on the defendant's new product sales.

Factor 3: Did the patent holder have the manufacturing and marketing capacity to exploit demand? The court found that it had.

Factor 4: What was the amount of profit the patent holder would have made?
The defendant contended that there was no proof that the plaintiff was entitled to 100% of the sales of his product. The Court disagreed - see above. Finally, the defendant called the plaintiff's report unreliable because it calculates lost profit per item, lacking the defendant's sales record. The Court disagreed, stating that the report was sufficiently accurate to pass *Daubert* and *Panduit*. See: http://www.NYNJCT-BV.com/Roll-Rite v Shur-co EDMI.pdf

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J.L. Pierson, ASA is an experienced business appraiser who supports the NY, NJ and CT business community from his base in Darien, CT. His clients are closely-held businesses with revenues of up to $300 million in all industries, as well as owners of family limited partnerships/LLCs, professional corporations and their advisors. He specializes in business valuation for estate/gift tax, succession planning, sale/purchase and litigation such as shareholder and corporate disputes and divorce, corporate development and transactional support purposes. This newsletter is generated internally to reflect key development in BV which appear to affect users. Court decision analysis is prepared from the perspective of a BV analyst, not from that of an attorney.

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