

MEMORANDUM

SUPREME COURT - STATE OF NEW YORK  
COUNTY OF NASSAU

PRESENT:

HON. IRA B. WARSHAWSKY,

Justice.

TRIAL/IAS PART 10

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In the Matter of the Application of  
EDWARD MURPHY, et al.,

Petitioners,

INDEX NO.: 002640/2006

Shareholders in United States Dredging Corporation,

-against-

UNITED STATES DREDGING CORPORATION,  
et al.,

Respondents.

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DECISION AFTER TRIAL

This matter was tried before the court over a three day period, November 27-29, 2007. The court was familiar with the parties having presided over a derivative action brought by these same movants against the officers and directors who are also the majority shareholders.

FINDINGS OF FACT

This is a special proceeding for judicial dissolution of a Corporation commenced by Regina M. Adams, Joan Murphy, Eileen Gallagher Poczatek, Maraline Murphy, Maureen Gibbons, Nannette Meyers, and Edward Murphy ("Petitioners" and/or "Petitioner" and/or "Minority Shareholders"), against certain Shareholders of United States Dredging Corporation ("Respondent" and/or "USD" and/or "Corporation"), by Petition filed on February 14, 2006 (the "Commencement Date") (see Petitioners' Exhibit "1") and Amended Petition (see Petitioners' Exhibit "2"), brought pursuant to Business Corporation Law ("BCL") § 1104-a on the grounds that the Directors or those in control of the Corporation have been guilty of oppressive actions

toward the Petitioners as minority shareholders.

USD is a corporation, incorporated in New York State on October 24, 1934. As of February 13, 2006, the Valuation Date as fixed by this court in its ruling on December 14, 2007, the Corporation had 4,333.333 shares issued and outstanding.

The Petitioners collectively represent a 36.77% interest in the Corporation (see Petitioners' Exhibit "4").

USD and the Corporation's shareholder Directors, James F. Murphy, John J. Murphy (now deceased) and Michael J. Gallagher ("Directors"), as well as non-petitioning shareholders Jayne Gallagher and Rosemarie Codus contested the allegations of oppression, but after Respondent USD's motion for dismissal of the Petition was denied by Order of this court dated October 25, 2006, an answer was filed which did not contest Petitioners' 36.77% ownership of the shares in USD.

Respondent, USD, with leave of the court, elected, pursuant to BCL § 1118, to purchase Petitioners' shares of USD, thus, consenting to the dissolution, but not to a buyout price.

Despite attempts at settlement, the parties were unable to agree upon a price of those shares (see Petitioners' Exhibit "3"), thus necessitating this valuation proceeding and a hearing which provided the court with dueling experts.

All of the shares of USD are subject to an agreement dated April 16, 1956, between the original shareholders (the "Agreement"), requiring that any shareholder wishing to sell his or her shares in the Corporation must first offer their shares to the existing shareholders of the Corporation. Said agreement plays no role in the matter currently before the court.

In 2005, USD sold its main asset, real property located in Red Hook, Brooklyn, New York, to IKEA for \$31.25 million.

At the time of this closing on June 2, 2005, USD held two substantial assets: the \$29.1 million net proceeds from the IKEA sale and real estate located in Avon, Connecticut that was net leased to CVS and had been acquired as part of a tax exempt exchange upon the disposition of other real property owned by USD in New Jersey.

The purchase price of the Avon, Connecticut property was \$3.9 million, and USD twice mortgaged this property for a total of \$3.5 million (see Petitioners' Exhibit 4).

In June 2005, USD held cash assets in excess of \$33 million as well as an interest in the

real property located in Avon, Connecticut that had been acquired in 2001.

The Directors, who have controlled the Corporation for in excess of twenty (20) years, decided to have USD reinvest \$25.8 million of the proceeds via tax-free exchanges pursuant to Section 1031 of the Internal Revenue Code (26 U.S.C. § 1031), by acquiring properties in Toledo, Ohio, Vernon, Connecticut and Sun City, Florida.

The Toledo property is held in the name of a wholly owned subsidiary of USD, Dredging Toledo, LLC.

In conjunction with the Toledo property acquisition, USD received \$16 million in mortgage financing proceeds (see Petitioners' Exhibit "4"), which sum is apparently held by USD in an account at Alliance Bernstein.

The Corporation's revenues are essentially fixed and subject to long-term leases (see Petitioner's Exhibit 4).

The Avon, Connecticut property is "triple net leased" to CVS Caremark through January 31, 2023.

According to trial testimony, a triple net lease means that the lessees pay all expenses for the property (see Fielstein testimony, page 315, lines 8-10).

The lease is renewable, at CVS's option, in five-year increments, through 2073. Rent for the first three renewal periods is fixed at \$306,900 per year. Thereafter, rent is to be at fair market value (see Petitioners' Exhibit 10 and Respondent's Exhibit BBB).

The Toledo, Ohio, property is triple net leased to Wal-Mart through January 15, 2024. The lease is renewable, at Wal-Mart's option, in five-year increments, through 2099, at a fixed rent of \$1.4 million per year (see Petitioners' Exhibit 13 and Respondent's Exhibit FFF).

The Vernon, Connecticut property is triple net leased to Walgreen's through September 1, 2075. Walgreen's has the option to terminate the lease at the end of every five years after September 1, 2030. The minimum annual rent, through the term of the Walgreen's lease, is \$403,000.

Rent due under the lease could exceed the minimum based on a pre-agreed formula of 2% of gross sales, excluding the sale of food items, plus 0.5% of gross sales of food items and non-third party prescription items (see Petitioners' Exhibit 14 and Respondent's Exhibit GGG).

The Sun City, Florida, property is a single-family residence. It is triple net leased to a

non-petitioning shareholder of the Corporation, who in a previous proceeding, testified in support of USD's management and who has received health insurance benefits from the Corporation although not an employee.

This Sun City, Florida, lease is for four (4) year terms through August 31, 2025, at a fixed rent of \$16,800 per year. The terms of the Sun City, Florida, lease specify that the tenant has the option, at any time during the lease, to purchase the property.

The Sun City, Florida, purchase price is fixed at \$280,000 through August 2008. Thereafter, the purchase price will be adjusted annually to reflect increases in the Consumer Price Index. Alternatively, the landlord has the right, at any time after August 2007, to require the tenant to purchase the property. In this case the purchase price would be fixed at \$280,000 and the Corporation has the right to redeem the shareholder's shares as consideration if the shareholder defaults in its obligation to purchase the property (see Petitioners' Exhibit 17 and Respondent's Exhibit YY).

Trial testimony characterized this real estate portfolio as low return but low risk (see Fielstein testimony, page 316, lines 18-19) and proffered that, based on the fact that three of the four rentals are significant and substantial retailers (CVS, Wal-Mart and Walgreen's), the Corporation has a very stable operation from the perspective of cash flow (see Fielstein testimony, page 315, lines 12-15).

By exchanging the properties, previously owned by USD, for other properties in what is known as a 1031 exchange, the corporation was able to avoid paying over \$11 million in capital gains taxes on said sales. When one or more of the properties is sold the built in gains tax would then have to be paid on that property or properties. The built-in gains tax is commonly referred to as the B.I.G. or the B.I.G. tax.

At trial, the expert witnesses for both Petitioners and Respondents opined that the valuation of a real estate investment company such as USD could be best valued utilizing either the Adjusted Book Value Method (Cost Approach) or the Income Approach (see Fielstein testimony, page 319, page 330; see McAteer testimony, pages 26-27) or both. Both experts utilized the same valuation methodologies in their respective reports, the net asset (cost) approach and the income (discounted future cash flow (or "DFCF")) approach. However, as one would expect in a case of this nature, each expert weighted the two approaches differently and

reached different values as to each area.

Respondents expert, Mr. McAteer, testified that in the event that the court did not accept the entire built in capital gains tax [B.I.G.] as a liability of the company (which he chose to do), in the net asset approach, then he would weight the DFCF method 85% and Mr. Feilstein did not disagree with that approach, but did not opine on the number. It was also suggested that the DFCF method could be used as the sole method in determining the fair value of the Corporation (see TR. 582-88). It would appear that the parties agree that the court has the discretion to choose the method or methods to be used in valuing the company. See In Re Seagroatt, 78 N.Y. 2d 439, 445 (1991). In Matter of LaSala, 2/6/2003, NYLJ, p. 24, col. 1, the court found the “cost” or book value approach was best for a real estate investment company.

The Petitioners’ expert, Howard Fielstein of Margolin, Winer & Evens LLP, testified that based on the Adjusted Book Value Method (Cost Approach), the fair value of the Corporation’s equity as of the Valuation Date was equal to \$24,758,500 (see Exhibit 3 of Petitioners’ Exhibit 4).

Mr. Fielstein further testified that based on the Income Approach, the fair value of the USD’s equity as of the Valuation Date is approximately \$20,007,000 (see Exhibit 9 of Petitioners’ Exhibit 4).

Thus, in the opinion of Mr. Fielstein, the Petitioners’ combined ownership interest of 36.77% has an indicated value of \$9,103,700 under the Cost Approach and \$7,356,000 under the Income Approach (see Petitioners’ Exhibit 4), both as of the Valuation Date.

Respondents argue that the court must reject Mr. Feilstein’s conclusions, in that he disregarded New York law in not using a willing buyer test, and he omitted both liabilities of USD as well as including certain assets improperly.

To reconcile these aforesaid values, Petitioners’ expert, Margolin, Winer & Evens, applied a weighting of 55% to the Income Approach method and a weighting of 45% to the Cost Approach method, under the belief that the long-term nature of the real estate and mortgage financing transactions which the Corporation has entered into argues for giving slightly greater weighting to its expected long-term cash flow than to an estimate of the current values of its discrete, and highly encumbered assets (see Petitioners’ Exhibit 4).

Applying a weight of 55% to the value determined under the Income Approach and a

weight of 45% to the fair value determined under the Cost Approach, he concluded value of the Petitioners' shares as of the Valuation Date was equal to \$8,143,000 (see Petitioners' Exhibit 4 at Exhibit 9).

In reaching his conclusion, Petitioners expert made no deduction nor discounted the value of the Corporation based upon the illiquidity of the shares, sometimes known as an illiquidity discount or lack of marketability discount; and he only deducted a discounted value of the B.I.G. tax rather subtract the entire amount in determining the fair value of USD.

Conversely, Respondent's expert Mr. McAteer, of Holtz Rubenstein Reminick LLP determined the fair value of Petitioners' shares to be \$3,761,000 (see Petitioners' Exhibit 25) as of July 13, 2006, five months after the Valuation Date of February 13, 2006. He used a 15% illiquidity discount and subtracted the entire B.I.G. tax in reaching his conclusion (the court fixed February 13, 2006 as the Valuation Date after Mr. McAteer filed his report).

The Respondent's expert, in determining Petitioners' interest in the Corporation to be \$3,761,000.00 valued the Corporation before adjustments using a Cost (Asset) Approach at \$15,015,000 and Income Approach at \$11,403,000 (see Petitioners' Exhibit 25), weighing the Income Approach at 50% and Cost (Asset) Approach at 50% as of the Valuation Date (see McAteer testimony, page 29, line 8).

Numerous factors provide for the difference in the valuations that were reached by the two experts. One was the fact that on March 29, 2006 the board of directors voted to adopt a pension plan, obviously benefitting only the directors and their estates (Exhibit RR). The respondents' expert reduced the value of the Corporation by the value of the pension plan and considered the pension plan a liability of the Corporation though the pension plan did not exist as of February 13, 2006.

Another is the fact that the directors continued to compensate themselves at a rate which this court had found improper in its decision dated July 6, 2005. However, it must be recalled that the court's decision of July 2005 has no prospective impact, and the court has never ruled as to the propriety or impropriety of the salary that was being given to the directors at any time after the court's decision nor at any time that postdated the period of time that was covered by the court's decision. This does not in any way mean that this Court believes that the salaries taken by the directors were appropriate or fair compensation for the work that they did.

However, there is no decision that can be used by the Petitioners which would allow them to reduce the salaries of the directors for the purposes of the fair value computation. Another factor that was considered by the respondents expert in reaching his fair value computation was the fact that the court granted a motion that allowed the directors to be reimbursed for their legal fees relating to the prior action which this Court has previously referred. The court will rule separately on the status of the deductibility of the attorney's fees for the directors and that of the value of the pension plan as a liability. The court's only concern at this point is that what it had ruled were overpayments of salary to the officers and directors, have been refunded to the Corporation. If they have not yet been refunded to the Corporation, either by reducing compensation that was to have been paid to them or they having actually repaid set amounts, then those amounts are to be included in the value of the Corporation. However, the difference in valuation is not only attributable to the above recited factors which occurred after the valuation date.

In December of 2005, in a letter to all shareholders (Exhibit JJ), the President of USD offered to repurchase the shares of Petitioners based on a liquidated value of \$12,300,000 (see Petitioners' Exhibit 6, 62, and 62A), without considering a \$1 million dividend which was declared in January, 2006. Petitioners' 36.77% of the \$11.3 million would be \$4.155 million, slightly less than McAteer's (unweighted) net asset value of \$4.325 million (Exhibit A at Exhibit 2A and Exhibit 5 of Exhibit A), which was discounted. After discounting, the McAteer fair value computation was slightly over \$3.5 million.

The Respondents choose to differentiate the December 2005 offer from President James F. Murphy, which was considered a liquidation value offer, from the fair value computation of Mr. McAteer. They point out that there were numerous costs that would have to be deducted from the December 2005 buyout offer before anything would actually be paid (lawyers' fees, accountants' fees, etc.). All though it is not essentially relevant to the courts final decision in this case, the Court believes that only attorneys and accountants could have come up with these deductions and that if an agreement had been reached, much of the proposed "deductions" would have been avoided. It is regretful that the animosity that existed and still exists amongst these family members prevented them from considering the December 2005 offer. Now, we do have attorneys fees and experts fees that will reduce what ever award is made by the court.

The valuation for this proceeding is to be at "fair value" of a going concern. BCL § 1118. Respondent's expert valued both the Corporation and Petitioners' interest in the Corporation at less than the Corporation's own calculation of value based on liquidation. Though the respondents expert denies that his calculations resemble a liquidation value, and points out that none of the costs of liquidation were included in his calculations, he chose to treat the built in gains tax (B.I.G.) as though it was being paid in one lump sum at the time of the purchase of the Petitioners shares and deducted it in its entirety.

Petitioners continuously harp back to the value of the Corporation as of June 2005. It is at that time that the majority of the assets of the Corporation were held in cash, shortly after the IKEA sale had culminated. They then proceed to raise an argument that the reason that the cash does not exist today is because the directors have chosen to invest a large portion of that amount in real estate. All that is a matter of fact. It has no relevance to the courts decision. There is no action before this Court that the directors were derelict in their duties or acted improperly in any way as to the investment of the IKEA sales proceeds. No part of that argument will be considered by the court. However, when an expert comments on lack of marketability or instant liquidity due to the type of asset as had Mr. McAteer, the court will consider that it was the investment decisions of the directors, who have controlled the company for twenty years, that has resulted in this non-marketability. The creators of the cause of the non-marketability should not gain from their handiwork.

It is agreed that the cash dividend paid to the Petitioners in January 2007, paid after the valuation date, will be considered a credit to the purchase price.

EQUIPMENT - There were differences in assets and liabilities of each report . As per the August 2007 deposition of James F. Murphy (see Petitioners' Exhibit 23), the crane and tug were valued at \$40,000. Petitioners' expert took half as a conservative number, of \$20,000. Petitioners' expert added \$28,000 for five cars that were not on the books, for a total of \$48,000 (see Fielstein testimony, page 381, lines 16-21). Respondents argue that only three cars were shown on the books and records of USD as of the 2005 tax return (exhibit W.). They further argue that the crane is owned by an entity other than USD. Furthermore there is no evidence that the tug or a second crane referred to in the Petitioners appraisal are of any marketable value. Petitioner Relies on the testimony of James Murphy to support these miscellaneous claims of

