SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NASSAU

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SERGIO MAGARIK, individually and derivatively on behalf of KRAUS USA INC.,

Index No. 606128/2015
(DeStefano, J.)

Petitioner,

- against –

KRAUS USA INC., MICHAEL RUKHLIN and RUSSELL LEVI,

Respondents.

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PETITIONER'S PROPOSED POST-TRIAL
FINDINGS OF FACTS AND CONCLUSIONS OF LAW

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Pursuant to the Court's instructions, Petitioner Sergio Magarik ("Petitioner" or "Magarik") respectfully submits these proposed findings of fact and conclusions of law.

PROCEDURAL HISTORY

1. The Petition in this case was filed on September 21, 2015. It contained several causes of action against Respondents, including for breach of contract, breach of fiduciary duty, waste, conversion and fraud. *See* Court Exhibit 1. By stipulation dated July 26, 2018, all but the first cause of action, for dissolution of Kraus USA, Inc. ("Kraus" or the "Company"), were withdrawn. Additionally, Respondents had asserted a counterclaim against Magarik for breach of fiduciary duty. *See* Court Exhibit 2. By stipulation dated November 30, 2017, the counterclaim was withdrawn.

2. Pursuant to Section 1118(a) of the Business Corporation Law, Respondents elected to purchase Magarik's 24% ownership interest in Kraus.

3. Accordingly, the only issue remaining to be determined in this matter is the value of Magarik's 24% ownership interest in Kraus as of September 20, 2015 (*i.e.*, the day before the Petition was filed, the "Valuation Date").

4. A bench trial was held on November 14 and 15, 2018, February 25, 2019, March 5, 2019, April 3 and 4, 2019, and May 15, 2019. The Court heard extensive testimony from the parties' valuation experts: Randall M. Paulikens on behalf of Petitioner and Paul G. Marquez on behalf of Respondents. The Court also heard testimony from Magarik, Respondents Russell Levi ("Levi") and Michael Rukhlin ("Rukhlin"), as well as from Kraus' chief financial officer, Daniel Lusby.

5. As set forth below, the Court concludes that Magarik's 24% interest in Kraus was worth $7,221,600 on the Valuation Date.

FINDINGS OF FACT

A. Kraus and its Shareholders

6. Kraus was founded in 2007. Stipulated Facts at ¶ 1.

7. Pursuant to a Certificate of Incorporation dated February 23, 2007, Kraus was incorporated under the laws of the State of New York. *Id.* at ¶ 2.

8. Kraus is a sub-chapter "S" corporation for federal and state tax reporting purposes. *Id.* at ¶ 3.

9. The Company has three shareholders. *Id.* at ¶ 4.

10. Levi owned 51% of Kraus; Rukhlin owned 25% of Kraus; and Magarik owned 24% of Kraus. *Id.* at ¶ 5.

11. Levi served as President of the Company. His duties included, but were not limited to, the determination and formulation of policies as well as overall supervisory responsibility for the Company. *Id.* at ¶ 6.

12. Rukhlin served as the Executive Vice President of the Company. His duties included, but were not limited to, monitoring the financial aspects of the Company and overseeing various administrative matters. *Id.* at ¶ 7.

13. Magarik also served as Executive Vice President of the Company. His duties included, but were not limited to, overseeing sales and some marketing functions of the Company. *Id.* at ¶ 8. As Magarik testified, he was instrumental in launching the Kraus brand at the Kitchen and Bath Industry Show in 2007, promoting the Kraus name through advertising (including digital advertising), positioning Kraus online, and getting Kraus' products sold through different distribution channels, including e-commerce. Trial Tr. at pp. 487, 499, 501, 504, 517. The Court credits Magarik's testimony.

B. The Business of Kraus

14. Kraus is an importer and distributor of sinks, faucets and complimentary plumbing fixtures and related accessories. Stipulated Facts at ¶ 9.

15. Prior to 2010, the Company maintained office and warehouse space in Long Island City, New York. *Id.* at ¶ 10.

16. As of September 2015, the Company occupied an office and warehouse space in Port Washington, New York pursuant to an operating lease that commenced in June of 2010 and was to expire by its terms on May 31, 2016. *Id.* at ¶ 11.

17. The Company also occupied a warehouse in Syosset, New York, pursuant to an operating lease that commenced in November of 2011 and which was renewed, in writing, as of January 31, 2012 and was to expire, by its terms, on May 31, 2017. *Id.* at ¶ 12.

18. Kraus sells its products online through retailers and, at times, ships directly to the ultimate consumer, even though those transactions were between the reseller and the ultimate consumer. Some of the retailers do not take physical possession of the merchandise. *Id.* at ¶ 13.

19. Kraus has negotiated with Home Depot to have two of the Company's faucet models offered in 93 of Home Depot stores. *Id.* at ¶ 14.

20. Kraus' financial statements were compiled by Morris Tepper, CPA for the years 2012 and 2013. *Id.* at ¶ 15.

21. The accounting firm Brand Sonnenschine, LLP prepared and reviewed Kraus' financial statements for the years 2014 and 2015. *Id.* at ¶ 16.

C. Kraus' Rapid Growth

22. The Company experienced tremendous growth in the years prior to the Valuation Date, having increased sales from approximately $21 million in 2012 to approximately $36

million in 2015. Exhibit 62; Trial Tr. at p. 441. Both experts acknowledged Kraus' substantial growth prior to the Valuation Date.

23. Mr. Paulikens testified that Kraus showed "significant growth in sales over a very short period in an industry that is fairly stable ...." Trial Tr. at p. 62. As he explained, "we're trying to understand what the market would perceive of Kraus in September 2015. Growth and significant growth is generally very well rewarded by the market and other outsiders because with sales growth eventually will become profits. That's the perception. So the fact that it [the Company] had grown to nearly twice the size in only four years was a significant factor." Trial Tr. at p. 74.

24. Likewise, Mr. Marquez agreed that Kraus' financial statements showed that Kraus' sales grew significantly in the years before the Valuation Date of September 20, 2015. Trial Tr. at pp. 810-11. *See also* Mr. Marquez's report (Exhibit 3) at p. 4 (stating that from the beginning of 2009 through late 2015, the Company's sales revenues "increased significantly" and that the net effect on revenues was a 30 percent compound annual growth rate from 2010 to September 2015). Mr. Marquez also acknowledged that in the years prior to the Valuation Date, Kraus sacrificed profits for growth, in order to achieve greater profitability in the future. Trial Tr. at pp. 814-17.

D. Kraus Builds a Brand

25. The parties dispute the extent to which Kraus had established itself as a "brand" of sinks and fixtures as of the Valuation Date. This issue is relevant because Mr. Paulikens testified that his market approach to valuation (discussed below) sought to capture value associated with the fact that Kraus sold branded products, as opposed to unbranded ones.

26. The evidence at trial established that Kraus was formed in order to create a brand of kitchen and bath products, and that it had established itself as a brand as of the Valuation Date. This evidence included the following:

a. Magarik testified that the "idea of Kraus was to create a brand, a distinct and unique brand offering something innovative, something creative, something very different than what existed at that time, and make certain that brand is sold through multiple channels of distribution online as well as brick and mortars." Trial Tr. at pp. 492-93.

b. Kraus placed its name and logo on its products, packaging and warranty information. Trial Tr. at p. 429.

c. Levi admitted that "Kraus is a brand." Trial Tr. at p. 420.

d. In 2013, Kraus described itself in writing as a "fast growing manufacturer and distributor of sinks and faucets, complementary plumbing fixtures and related accessories" and that Kraus had "rapid brand recognition". Exhibit 39; Trial Tr. at p. 510.

e. As of March 2015, Kraus' website stated: "After years of exponential growth, we became the leading brand to successfully bridge the gap from industrial-age production into global, digital-age manufacturing." Exhibit 84.

f. As of September 2015, Kraus had management level employees (Katia Palat and Katie Rivera) to assist in the promotion of the Kraus name, branding, sales and marketing. Trial Tr. at pp. 445-453, 508.

g. Like competitors such as Kohler and Delta, Kraus "had an R&D [research and development] department, had a graphics team, had a legal department, partner care, customer service [and] IT department." Trial Tr. at p. 607. The Company also had "a China team that was also part of the product development department because there was quite a bit done overseas." Trial Tr. at p. 623.

h. The Company represented to its lender in June 2015 that "[n]et revenues increased from $19.5 million in 2012 to $26.5 million in 2013 to $27.3 million in 2014 predominantly through organic growth, increased purchasing of plumbing fixtures, online outlets by consumers, focused marketing through our distribution partners, and an ever-increasing quality brand recognition." Exhibits 58 and 62; Trial Tr. at p. 465.

i. The Company further represented to its lender in June 2015 that "Kraus is at the precipice of significant growth after years of building a recognized quality brand." Exhibit 62; Trial Tr. at pp. 470, 515.

E. The BHI Loan and Management's Projections of Income

27. Prior to 2015, Kraus had a line of credit with JPMorgan Chase ("Chase"), with a borrowing limit of $4.5 million. The Company also had a $500,000 loan from Fertipham Trading Inc. ("Fertipham"). Stipulated Facts at ¶¶ 20-21.

28. In July 2015, Kraus refinanced the Chase and Fertipham debt by entering into a revolving credit note with Bank Hapoalim B.M. ("BHI"), pursuant to which BHI agreed to lend the Company up to $7 million subject to Kraus meeting certain performance conditions, which could be further extended up to $10 million, provided that the Company achieved certain additional milestones. *Id.* at ¶ 22.

29. Kraus provided several documents to BHI "as part of BHI's due diligence in considering whether to extend the line of credit and to determine the ultimate amount of the loan." Stipulated Facts at ¶ 23. Those documents were admitted into evidence at trial as Exhibit 58. Stipulated Facts at ¶ 24.

a. Management's Projections

30. One of the documents that Kraus provided to BHI was management's projections of the Company's future performance, dated June 8, 2015. Exhibits 41 and 58.

31. The projections that Kraus provided to BHI estimated Kraus' revenues for the period through 2015 and for 2016. *Id.*

32. The projections submitted to BHI were prepared by the Company's chief financial officer, Daniel Lusby. Trial Tr. at p. 962.

33. Mr. Lusby has been a licensed certified public accountant since 2002, and served as the controller of a number of companies before joining Kraus. Trial Tr. at pp. 947, 959-60.

34. Mr. Lusby, on Kraus' behalf, confirmed the reasonableness of the projections. The Loan and Security Agreement provides in relevant part: "The monthly cash flow projections of Borrower for the period May 1, 2015 through and including December 31, 2016 (the 'Projections') were prepared by the chief financial officer of Borrower, are based on underlying assumptions which provide a reasonable basis for the projections contained therein and reflect Borrower's judgment based on present circumstances of the most likely set of conditions and course of action for the projected period." Exhibit 47 at p. 32, § 5.5(b).

35. Mr. Lusby testified that he reviewed this provision, Section 5.5(b) of the Loan and Security Agreement, before Kraus signed it. Trial Tr. at p. 963.

36. Prior to the Loan and Security Agreement being entered, Magarik sent an email to Mr. Lusby, asking him to confirm the accuracy of the representations contained in Section 5.5 of the agreement. Exhibit 88.

37. In that email, sent on June 1, 2015, Magarik wrote to Mr. Lusby as follows: "Dan, regarding the Loan Docs since we are almost wrapped up, I just want to make certain that the representations contained in Section 5.5 are true and correct, because the bank will hold each of us personally accountable for the representations made by the company as a whole." *Id.* Magarik included a copy of the entire Section 5.5 in his email for reference. *Id.*; Trial Tr. at p. 967.

38. Mr. Lusby replied by email as follows: "Serge, I am fully aware of all these requirements/representations. I confirm and acknowledge them." Exhibit 88; Trial Tr. at p. 967.

b. Respondents' Own Estimates of Kraus' Value

39. As part of the due diligence process, BHI also asked for and received personal financial statements from all three shareholders (Magarik, Rukhlin and Levi). Exhibit 71 (Magarik's personal financial statement); Exhibit 72 (Levi's personal financial statement); and Exhibit 73 (Rukhlin's personal financial statement).

40. Each of those statements contains a certification right above the shareholders' respective signatures. The certification provides, in all capital letters, as follows:

> THIS IS TO CERTIFY THAT ALL THE STATEMENTS CONTAINED HEREIN AND IN ANY SUPPORTING SCHEDULES ARE TRUE AND GIVE A CORRECT SHOWING OF MY FINANCIAL CONDITION AS OF THE DATE INDICATED. ... IN THE EVENT OF ANY MATERIAL ADVERSE CHANGE IN MY FINANCIAL CONDITION, I AGREE TO NOTIFY [BHI] IMMEDIATELY IN WRITING. THIS FINANCIAL STATEMENT IS SUBMITTED TO INDUCE [BHI], FROM TIME TO TIME, TO EXTEND CREDIT, THE UNDERSIGNED WELL KNOWING THAT [BHI] WILL RELY UPON THE ACCURACY OF ALL INFORMATION AND REPRESENTATIONS CONTAINED IN THIS FINANCIAL STATEMENT.

Exhibits 72 and 73.

41. In his personal statement, Rukhlin valued his 25% interest in Kraus at $7.5 million. Exhibit 73; and Trial Tr. at p. 409. That equates to a valuation of Kraus, as a whole, of $30 million. *Id.*

42. In his personal statement, Levi valued his 51% interest in Kraus at $15.3 million. Exhibit 72; and Trial Tr. at p. 474. That equates to a valuation of Kraus, as a whole, of a little more than $30 million. *Id.*

43. After submitting their personal financial statements to BHI to induce BHI to extend credit, neither Rukhlin nor Levi ever informed BHI in writing of any material adverse change in their respective financial conditions. Trial Tr. at pp. 407, 472.

44. Rukhlin testified that he was aware that it is a federal crime to submit false information to a lending institution for the purpose of inducing credit. Trial Tr. at p. 408.[1]

45. Because Rukhlin and Levi made those certified written representations to BHI – prior to this litigation and under the penalty of a federal felony – the Court credits those representations. The Court does not credit the trial testimony of Rukhlin and Levi in which they tried to distance themselves from the representations they made to BHI.

46. Following the BHI loan closing in July 2015 and through at least September 20, 2015, the Company placed orders with its manufacturers for approximately $2 million in new products. Stipulated Facts at ¶ 29.

47. The BHI loan was significant, not only because of the representations made by Respondents to induce the loan and the increased ability for Kraus to continue growing by buying and selling new products, but because the extension of the loan provided an insight into how the market viewed the value of Kraus. As Mr. Paulikens explained, "[BHI] put their money into Kraus expecting to get it back. So to me, the bank put in or made available $7 million in capital for Kraus. And it's a big increase. ... So that is an indication to me of a positive outlook for Kraus." Trial Tr. at p. 88.

48. As Mr. Paulikens further explained, "When you're valuing a privately held company or even valuing a publicly held company, you seek to understand all of the information that was available to the participants in the market, the buyer, the seller, as of the measurement date. It's not done in a vacuum. You need to understand what was going on. ... [T]he biggest factor is the bank, BHI. And in July of 2015, BHI lent Kraus, gave them a credit facility that increased their borrowing ability from $4 million to $7 million with the ability to get as high as

[1] *See* 18 U.S.C. § 1014. The penalties include up to 30 years in prison and a fine of up to $1 million. *Id.*

$10 million assuming certain covenants were met. That's a significant outsider's look as to what the expectations for Kraus were at the time." Trial Tr. at pp. 46-47.

CONCLUSIONS OF LAW

A. Legal Standards

49. Section 1118(a) of the New York Business Corporation Law provides:

> In any proceeding brought pursuant to section eleven hundred four-a of this chapter, any other shareholder or shareholders or the corporation may, at any time within ninety days after the filing of such petition or at such later time as the court in its discretion may allow, elect to purchase the shares owned by the petitioners at their fair value and upon such terms and conditions as may be approved by the court, including the conditions of paragraph (c) herein.

N.Y. Bus. Corp. Law § 1118(a).

50. In the event the shareholders of a corporation are unable to agree upon the fair value of petitioner's shares,

> the court, upon the application of such prospective purchaser or purchasers or the petitioner, may stay the proceedings brought pursuant to section 1104-a of this chapter and determine the fair value of the petitioner's shares as of the day prior to the date on which such petition was filed, exclusive of any element of value arising from such filing but giving effect to any adjustment or surcharge found to be appropriate in the proceeding under section 1104-a of this chapter.

N.Y. Bus. Corp. Law § 1118(b).

51. To determine the value of a petitioner's shares under BCL § 1118, neither party bears the burden of proof. As explained by the court in *Matter of Cohen*, 168 Misc. 2d 91, 95 (Sup. Ct. N.Y. Cty. 1995), *aff'd*, 240 A.D.2d 225 (1st Dep't 1997), the statute "defies application of a burden-of-proof approach. That each party presented their views of the value of petitioner's shares through expert testimony does not require or even invite the court to measure value using or rejecting either or both opinions of value." *Id.*

52. "In fixing fair value . . . courts should determine the minority shareholder's proportionate interest in the going concern value of the corporation as a whole, that is, what a willing purchaser, in an arm's length transaction, would offer for the corporation as an operating business." *Friedman v. Beway Realty Corp.*, 87 N.Y.2d 161, 161–62 (1995). "[F]air market value, being a question of fact, will depend upon the circumstances of each case; there is no single formula for mechanical application." *Matter of Seagroatt Floral Co., Inc.*, 78 N.Y.2d 439, 445 (1991).

53. As explained further by the Court in *Seagroatt*, "[v]aluing a closely held corporation is not an exact science. Accordingly, courts in such proceedings confront a variety of evidence and methods aimed at determining the price of minority interests in closely held corporations – legal entities that by their nature contradict the concept of a 'market' value." *Id.* at 445.

54. In reaching such determination, courts have recognized that "[t]he three major elements of fair value are net asset value, investment value and market value." *Friedman*, 87 N.Y.2d at 167. However, "[t]he particular facts and circumstances will dictate which element predominates, and not all three elements must influence the result." *Id.*

55. Thus, the Court has broad discretion to determine a valuation that rests primarily upon the credibility of expert witnesses and their valuation techniques. *See Ferolito v. Arizona Beverages USA LLC*, No. 004058-12, 2014 WL 5834862, at *7 (Sup. Ct. Nassau Cty. Oct. 14, 2014); *see also DeAngelis v. AVC Servs., Inc.*, 57 A.D.3d 989, 991 (2d Dep't 2008) (recognizing that the determination as to the value of a business will not be disturbed on appeal where the valuation "rests primarily on the credibility of the expert witnesses and their valuation techniques").

B. Both Experts Utilized Accepted Valuation Methodologies

56. Both experts, Mr. Paulikens for Magarik and Mr. Marquez for Respondents, utilized income and market approaches to valuation.

57. Under the income approach, the valuation expert seeks to ascribe a value to what an investor could expect to receive in the future. Mr. Paulikens described the income approach as follows: "You're looking at the future benefits that ownership interest will provide to the holder and you try to determine what the future benefits are and bring them down to a present value as to what you would pay for those benefits today. That's the income approach. You're doing it on income, revenue, but some measure of the present value of the benefit stream, including capital appreciation." Trial Tr. at p. 91.

58. Under the market approach, comparable companies are analyzed to determine the value of the subject company. *Id.*

59. Both methodologies are accepted in the business valuation industry, and the question for the Court is which expert's application of these methodologies is more reasonable.

C. The Court Credits Mr. Paulikens' Income Approach

60. The Court finds that Mr. Paulikens' income approach, utilizing a discounted cash flow methodology, was more reasonable than the income approach used by Mr. Marquez.

61. The threshold matter is whether the use of projections, as opposed to historical data, is reasonable. This is a pivotal question because the outcome of a valuation analysis depends on what information is put into the analysis. Mr. Paulikens used the projections prepared by Kraus' management and provided to BHI for the purpose of obtaining the line of credit just a few months prior to the Valuation Date. Mr. Marquez, on the other hand, used Kraus' historical figures.

62. The Court finds that the use of the projections Kraus provided to BHI is appropriate here because: Kraus was experiencing tremendous growth; Kraus' management prepared the projections, and approved them as reasonable; Kraus submitted the projections to BHI to induce the loan under the penalty of a federal crime; BHI relied on the projections as part of its due diligence; and BHI decided to extend the loan, providing a compelling insight into how the market viewed the value of Kraus at that time.

63. As all parties agree, the Company was growing rapidly in the years leading up to the Valuation Date and had not stabilized to the point of steady, constant profit levels. As a result, Kraus' historical financial information would not provide an accurate indication of its expected future performance.

64. According to Mr. Paulikens, Kraus' revenue growth "by any measure was significant, and the market tends to reward high growth companies, especially in industries where they're taking market share from others." Trial Tr. at p. 63.

65. Mr. Paulikens further explained that "valuation is a look to the future. You don't buy stock based on what it did five years ago. You buy stock as to whether it's going to go up tomorrow or next year." Trial Tr. at p. 46.

66. Mr. Marquez, Respondents' expert, also has acknowledged that, as a general matter, the use of projections is preferable when performing valuations. In an article authored by Mr. Marquez, he wrote:

> We must allow our common sense to prevail if we are to make our way through these issues. Let's not forget that potential buyers create the market. We have placed ourselves in the position of would-be buyers for the business we're trying to value.
>
> Let's start with the issue of which earnings to use. It would be easiest to use the most recent year's earnings directly from the latest tax return. But, does that make any sense? Not in my opinion. A buyer is

> buying the future, not the past. Projected earnings, therefore, is my answer to which earnings figures to use.
>
> The obvious problem with this is that it is difficult to estimate. But it's still the right figure to use. It makes sense to most buyers as long as the projection looks realistic.

Exhibit 86; Trial Tr. at pp. 823-824.

67. Nevertheless, Mr. Marquez did not use the Company's earnings projections supplied to BHI. He instead used the historical numbers in a "single period capitalization model". Trial Tr. at p. 829. The Court finds that using the historical data was not the correct approach because, among other reasons, it did not reflect Kraus' undisputed rapid growth.

68. Mr. Marquez had his report in this matter peer reviewed by David Rudman, the President of Sigma Valuation (a company for which Mr. Marquez serves as a director). Trial Tr. at p. 828.

69. In an article authored by Mr. Rudman and published on Sigma Valuations' website, he wrote:

> The single period capitalized earnings method [which Mr. Marquez used in this case] is best applied to stable profitable companies. In contrast, start-up companies rarely have stable earnings. Rather, most start-up companies experience significant losses for a reasonable period of time before reaching profitability and, eventually, achieving stability.
>
> As a result of variations in profits and cash flows during the early years, the DCF [discounted cash flow method, which Mr. Paulikens used and Mr. Marquez did not use] is the most commonly accepted valuation method by the valuation and investment community for the purpose of valuing start-up companies. In order to apply this method, it is necessary to obtain or develop cash flow projections.

Trial Tr. at pp. 830-31.

70. Mr. Rudman then explained in his article where such cash flow projections typically come from:

> Cash flow projections are typically available for start-up companies in business plans prepared by management. Such plans are often used by the company to raise capital. As part of the DCF method, the risk adjusted present value of these projections can be determined by applying appropriate rates of return that capture the risk inherent in the company's operations and projections. Obviously, the process of creating projections requires management to make educated guesses as to the future performance of a company.

Trial Tr. at pp. 831-32.

71. Mr. Marquez testified that he agreed with the statements read into the record from Mr. Rudman's article. Trial Tr. at pp. 830, 832.

72. A key question, therefore, is whether it was reasonable for Mr. Paulikens to rely upon the projections from Kraus' management.

73. The Court concludes that it was reasonable for Mr. Paulikens to do so. As discussed above, the projections were prepared by Mr. Lusby, Kraus' CFO and a certified public accountant with years' of experience as a controller; the projections (unlike the historical numbers) picked up the fact that Kraus had been growing rapidly; the projections were provided to BHI to induce BHI to extend the loan; Mr. Lusby confirmed the reasonableness of the projections before the loan agreement was entered into; the parties stipulated that the projections were among the documents BHI received as part of BHI's due diligence in considering whether to extend the line of credit and to determine the ultimate amount of the loan; as Rukhlin was aware, it would have been a federal crime for Kraus to have knowingly submitted false information to BHI in order to obtain the loan; and BHI decided to extend the loan, showing that the market believed the projections were indeed reasonable.

74. The Court also concludes that the assumptions included in Mr. Paulikens' approach were reasonable, including the following:

a. As mentioned, the projections given to BHI estimated revenues through 2016. For the subsequent four years through 2020, Mr. Paulikens applied a growth rate of 5% per year. Trial Tr. at pp. 110, 837-38. That growth rate was conservative – it was far lower than the growth rate the Company had experienced in prior years, and it was much lower than the growth rates used by Mr. Marquez. Mr. Marquez applied the following growth rates: 25% for 2016; 20% for 2017; 15% for 2018; 10% for 2019; and 4% for 2020. Trial Tr. at p. 836.

b. Since Kraus is an "S" corporation, the taxes flow through to the shareholders. Mr. Paulikens applied an effective tax rate of 40%. Trial Tr. at p. 379. That was more conservative than the analysis of Mr. Marquez, who applied an effective tax rate of 25%. Trial Tr. at p. 818.

c. Mr. Paulikens increased the interest expense to account for the increased borrowing limit per the loan agreement with BHI. As with the tax adjustment, the increased interest expense lowered Mr. Paulikens' valuation of the Company. Trial Tr. at pp. 379-80.

75. Under the income approach, Mr. Paulikens valued Kraus at $21,390,000 as of the Valuation Date.[2] The Court concludes that his analysis was reasonable.

76. On the other hand, the Court determines that Mr. Marquez's income approach was not reasonable. The main flaw in his approach was using historical figures and not the projections that the Company itself prepared, approved and submitted to BHI to induce BHI to extend the loan. As Mr. Marquez himself wrote in the article admitted as Exhibit 86, "Projected earnings, therefore, is my answer to which earnings figures to use." Mr. Marquez, however, did not follow that approach here even though the Company had been experiencing significant and rapid growth in the years leading up to the Valuation Date.

77. Mr. Marquez valued Kraus at $6.16 million under his income approach. Exhibit 3 at p. 20. Because he used a less reliable method (using historical numbers that did not pick up on the Company's rapid growth), Mr. Marquez's valuation of Kraus was unreasonably low.

[2] The income approach valuation of Kraus in Mr. Paulikens' expert report (Exhibit 2) was $19,647,000 but it contained a mathematical error, which Mr. Paulikens explained at trial without objection. Trial Tr. at p. 124.

78. The Court notes that Mr. Marquez's valuation figure is less than the amount of the credit facility extended by BHI (up to $7-10 million). Further, as Mr. Marquez acknowledged, if Kraus had met its 2016 projected earnings (the forecast submitted to BHI to induce BHI to extend the loan), then Kraus would have qualified for the full $10 million in funding. Trial Tr. at p. 850. The Court does not believe (and Respondents presented no evidence) that a bank would lend a company more money (as much as nearly $4 million more) than the value of the company.

D. <u>The Court Credits Mr. Paulikens' Market-Based Approach</u>

79. In addition to the income approach discussed above, both Mr. Paulikens and Mr. Marquez also used a market-based approach, which involves comparing the company to be valued with other businesses. Under this method, the expert derives a ratio (equity plus debt divided by revenue) that allows comparisons of companies of different sizes.

80. As Mr. Paulikens testified, there are two broad methods within the market approach – "[o]ne is to use private company sales, which there's data bases available to do that, and the other approach is the public company markets, which there are also data bases that cull the public company information." Trial Tr. at p. 126. Both of these methods are accepted in the valuation industry.

81. Mr. Paulikens used the public company approach. Mr. Marquez used the private company approach.

82. The Court concludes that the approach used by Mr. Paulikens was more reasonable.

83. Mr. Paulikens explained that he used the public company approach "to try to capture the aspect of the brand, which may or may not be fully captured in the income approach because Kraus is still growing, it hasn't reached maturity yet ... and understanding that Kraus

also had ... some e-commerce aspects which are different than traditional wholesalers." Trial Tr. at p. 128. "With e-commerce, even though you're technically a wholesaler, it's a different way of selling, so you can get your product far further than you would with a traditional wholesaler product that doesn't have its own brand." *Id.*

84. A service called Capital IQ is used in the public company market approach. Mr. Paulikens described it as "an information source that allows you to sort public company information. It accumulates its history, it accumulates its market cap, it accumulates which industries it might be, so you can use that to drill down and try to locate companies that have some similar characteristics to the subject company that you are looking at." Trial Tr. at p. 129.

85. Mr. Paulikens selected, for comparison purposes, public companies with similarities to Kraus, including companies that sold plumbing fixtures, companies that had an e-commerce model, and companies that sold building supplies (to capture the fact that plumbing fixtures often go hand-in-hand with new construction). Mr. Paulikens testified that those public companies are not a "perfect match to Kraus because Kraus doesn't fit in any one category. It's technically a wholesaler, but it also has a brand. It's e-distribution, intellectual property as part of its value. So while it's not necessarily a perfect match, each of them ... I believed has some relevance as an indication of the value of Kraus." Trial Tr. at p. 140.

86. Using the Capital IQ database, Mr. Paulikens then derived the ratios (equity plus debt divided by sales revenue) from companies in these industries and applied a 10% discount to account for Kraus' small size. Trial Tr. at p. 143. According to Mr. Paulikens, a discount was not required, and because Kraus is a high growth company, an increase – a premium – could have been used. Trial Tr. at pp. 143, 221-22. In his judgment, Mr. Paulikens felt a 10% discount was appropriate under the circumstances. *Id.*

87. Mr. Paulikens then applied the resulting ratio to Kraus' year-end 2015 financial results. The Court does not fault Mr. Paulikens for this. While the year-end results were not available by the Valuation Date (September 20, 2015), the Company's expected revenues for the year were known or knowable by the third quarter, given that orders had been placed. The Court also observes that if Mr. Paulikens had applied his ratio to the projected revenue figure for 2015 submitted to BHI, his valuation would have been higher. Trial Tr. at p. 144.

88. After subtracting the Company's debt (the BHI line of credit and shareholder loans), Mr. Paulikens arrived at a valuation of Kraus of $38,790,000 under the market approach. Trial Tr. at p. 145; Exhibit 2.

89. Mr. Marquez, on the other hand, used the private company comparison method in his market-based approach. He reviewed information from Pratt's Stats, a database for private company transactions. Trial Tr. at p. 701.

90. Pratt's Stats has some inherent limitations that are relevant here. Despite using Pratt's Stats, Mr. Marquez acknowledged such limitations. Trial Tr. at p. 876.

91. For example, as Mr. Marquez testified, the information in Pratt's Stats is typically reported only by the broker in the transaction (not the parties themselves). Trial Tr. at p. 876. And, unlike public company transactions, the information in Pratt's Stats is not vetted by the SEC. Trial Tr. at p. 258. As a result, according to Mr. Paulikens, "you have no definitive reliance that the numbers are even accurate." *Id.*

92. In addition, as Mr. Paulikens explained, "there is no trend analysis in Pratt's Stats for each of the subject companies. You don't know were they growing, were they shrinking, why they sold the company. ... It's not there. ... You don't know their growth trends, you don't

know their history ...." *Id.* Mr. Marquez agreed that Pratt's Stats does not provide such history and trending data. Trial Tr. at p. 879.

93. Since Kraus was a growing company in September 2015, these limitations in Pratt's Stats are important and limit the usefulness of that approach. *Id.* at p. 259.

94. Yet, even though Mr. Marquez acknowledged that Kraus' revenue was "growing at an outstanding rate" (Trial Tr. at p. 647), he still used Pratt's Stats in his market-based approach (*id.* at p. 701).

95. The companies that Mr. Marquez selected from Pratt's Stats were not similar to Kraus. Those companies were: an auto dealership; a distributor of office furniture; a company that distributes hydraulic and pneumatic parts; a fluid power distribution company; a metal stamping automotive; a manufacturer of conveyor equipment; an importer and distributor of lathes and mills; a distributor of water and sewer systems; a distributor of industrial automation products; a manufacturer of industrial commercial equipment used in the hospitality and restaurant industry; a fabricated steel manufacturer; a specialty harvesting equipment manufacturing company; a heavy equipment manufacturer; a metal recycling business; a designer, manufacturer and distributor of AR-15 and M-16 platform rifles, parts and accessories; and a metal fabricator. Trial Tr. at pp. 897-901.

96. Those companies did not sell the same kinds of products Kraus sells and did not sell their products in the same manner that Kraus sells. This further undermined Mr. Marquez's reliance on Pratt's Stats.

97. Under Mr. Marquez's market approach, he valued Kraus at between $5.3 million and $6.1 million. Exhibit 3 at p. 24.

98. As with Mr. Marquez's income approach valuation, the Court concludes that his market approach valuation is unreasonably low.

99. Because Mr. Marquez used a less reliable method, he reached a valuation of Kraus that is lower than the amount of money BHI agreed to lend to Kraus (up to $7-10 million). Again, the Court does not believe (and Respondents presented no evidence) that a bank would agree to lend a company more money (as much as approximately $4 million more) than the value of the company.

E. The Use of an Average of the Income and Market Approaches by Mr. Paulikens Was Reasonable

100. To arrive at his overall valuation of the Company, Mr. Paulikens took the average of his valuations under the income approach and the market approach, giving them equal weight. The Court concludes that this was reasonable.

101. As Mr. Paulikens explained, "In the income approach, because Kraus is still growing, I am not certain that it captures all of the e-commerce aspects or the total e-commerce because we're still not to stabilized growth and we have not fully captured the brand value or the implicit brand value in Kraus, so the income approach I think is good but I don't think it captures everything because it's on such a growth trend." Trial Tr. at p. 147.

F. It Was Reasonable for Mr. Paulikens Not to Apply a Discount for Lack of Marketability

102. The Court concludes that the 25% discount for lack of marketability ("DLOM") used by Mr. Marquez is unreasonable.

103. The Court notes that Mr. Marquez testified as an expert in a different valuation lawsuit under BCL Section 1118(a) (when he was hired by the petitioner, *i.e.*, the shareholder

who was being bought out), and he applied a discount of only 5% in that case. Trial Tr. at pp. 907-08.

104. The Court finds it reasonable that Mr. Paulikens did not apply a DLOM. Mr. Marquez acknowledged that a DLOM is not required (Trial Tr. at p. 907), and as Mr. Paulikens correctly pointed out at trial, Magarik has already waited several years to be paid, and has thus lost the time value of the money he is owed for his shares (*id.* at p. 371).

DETERMINATION OF THE VALUE OF MAGARIK'S INTEREST

105. Since the Court finds that Mr. Marquez's valuation analysis was fundamentally flawed, the Court is left only with Mr. Paulikens' valuation analysis, which the Court credits and finds reasonable.

106. Taking the average of Mr. Paulikens' valuation of Kraus under the income approach ($21,390,000) and his valuation of Kraus under the market approach ($38,790,000) yields a valuation of the Company of $30,090,000 as of the Valuation Date.

107. The Court adopts that valuation and observes that it is very close to the $30 million valuation of the Company that Respondents themselves represented in their personal financial statements submitted to BHI, to induce BHI to lend the Company money shortly before the Valuation Date.

108. For all of these reasons, the Court values Magarik's 24% interest in Kraus at $7,221,600 (i.e., 24% of $30,090,000).

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Respectfully submitted,

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