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TO BE ARGUED BY:
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TIME REQUESTED: 15 MINUTES

Supreme Court of the State of New York
Appellate Division: Second Department

In the Matter of
SERGIO MAGARIK, individually and
derivatively on behalf of KRAUS USA, INC.,
Petitioner-Appellant,

-against-

KRAUS USA INC., MICHAEL RUKHLIN and RUSSELL LEVI,
Respondents-Respondents.

Appellate Division Docket Nos. 2020-04299 2020-04302 2020-04303

BRIEF FOR PETITIONER-APPELLANT

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Supreme Court, Nassau County, Index No. 606128/2015

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QUESTIONS PRESENTED

1. Did the lower court commit reversible error in valuing appellant's shares of stock under Business Corporation Law § 1118 (which requires the valuation to be done as of the date before the petition was filed), when the lower court looked beyond the valuation date and, thus, applied an incorrect standard and otherwise reached a conclusion contrary to the law and the evidence?

PRELIMINARY STATEMENT

This case involves a single issue – the determination of the value of the shares owned by petitioner-appellant Sergio Magarik ("Magarik") in a company called Kraus USA Inc. ("Kraus" or the "Company"). Magarik filed a petition for the dissolution of the Company, and the other shareholders (Respondents) elected to buy Magarik out under Business Corporation Law § 1118(a). The sole issue tried by the lower court was the valuation of Magarik's shares – the price that Respondents must pay Magarik to buy him out.

By statute, the valuation date is the day before the petition was filed. *See* BCL § 1118(b) (the court must "determine the fair value of the petitioner's shares as of the day prior to the date on which such petition was filed"). Magarik filed his petition on September 21, 2015, so the valuation date is September 20, 2015 (the "Valuation Date"). That is the only date that matters for valuation purposes. As a matter of law, it does not matter what the Company is worth today, or any other day. Magarik was not even allowed to get discovery on Kraus' post-valuation date finances. R. 2665 (Special Referee's decision holding that "any evidence as to Kraus's financial performance after September 20, 2015 is not discoverable").[1] The lower court conducted a trial on the valuation issue in 2018 and 2019.

[1] Citations to "R. __" are to the record on appeal.

To determine the buyout price for Magarik's shares, the lower court needed to first determine the fair value of Kraus as a whole – i.e., how the marketplace (willing buyers and lenders) would value Kraus. Both sides agree that this is the standard under the case law to value a company.

To determine that value, both sides offered expert testimony and both experts used the same methodologies – the income approach and the market approach. There is no dispute that both of these approaches are accepted in the valuation industry.

Both experts also agreed that, under the income approach, the proper way to value a company is to use its income and expense *projections* (as opposed to the company's historical numbers) when the company is still growing, as long as those projections are realistic. Respondents' expert even wrote an article, appearing on his website, endorsing this very approach (i.e., the use of projections instead of historical numbers when a company is growing). R. 850-852, 2571-2598. The rationale is that the profits of a growing company have not stabilized, so using historical numbers is not an accurate way to value the company. Again, both experts agreed on this.

Both experts further agreed that Kraus was growing rapidly prior to the Valuation Date, and that its yearly profit levels had not stabilized. The lower court

acknowledged this as well. R. 7 (lower court describing Kraus as a "successful and growing business").

So, according to both experts, the *only way* Kraus' revenue projections should not have been used to value Kraus under the income approach was if the projections were not realistic. *But all of the evidence, including the testimony from every fact witness, showed that everyone – the parties and the marketplace – believed the projections were realistic:*

a. Indeed, right before the Valuation Date, Kraus submitted its revenue projections to a bank in order to get a multi-million dollar loan. Kraus prepared those projections, Respondents agreed with them, and Kraus' CFO signed off on them. Obviously, Respondents themselves believed that those projections were realistic. *In fact, as Respondents were aware, it would have been a federal crime for Respondents to submit false information to the bank in order to get the loan*. R. 433.

b. Likewise, Kraus' CFO also believed the projections were realistic and knew that it was important to give truthful information to the bank – and he even told Magarik so in an email before the projections were submitted to the bank. R. 2606-2609.

c. As part of that process, Respondents themselves also submitted personal financial statements to the bank, which included the value of their interests in Kraus. They told the bank exactly what they thought Kraus was worth and, *tellingly, their valuation was virtually identical to Magarik's expert's valuation. See infra*, Facts Established at Trial at § E(ii) and record cites therein.

d. The bank, in turn, considered and relied on Kraus' projections and approved the loan (a line of credit up to $7 million to $10 million). This was one of the facts that the parties stipulated to – i.e., that the bank considered the projections as part of its due diligence in deciding whether to extend the loan. R. 22 (at ¶ 23). The bank

certainly would not have made the loan if it thought the projections it received from Respondents were not realistic. Thus, not only did Respondents themselves believe that the projections were realistic, but the marketplace (i.e., a third-party bank deciding to lend millions of dollars) did as well.

e. Moreover, the Loan and Security Agreement with the bank expressly stated that the projections were prepared by Kraus' CFO, were "reasonable", and reflected Kraus' judgment of "*the most likely set of conditions and course of action for the projected period*." R. 1938 (§ 5.5(b)) (emphasis added).

At trial, Magarik's valuation expert followed the industry norm and relied on the projections that Respondents gave the bank right before the Valuation Date. Using the income approach, Magarik valued Kraus at $21.9 million.

Respondents' expert, on the other hand, did *not* use Kraus' own projections. Even though Respondents' expert agreed that the accepted practice in the valuation industry is to use projections to value a growing company like Kraus, and even though there was not a single witness who testified that the projections were unrealistic, and even though there was no evidence in the record that the projections were unrealistic, Respondents' expert plugged Kraus' *historical* numbers into his analysis to arrive at his low valuation. That was the main difference in the experts' respective income approach valuation analyses. Going against the industry norm, Respondents' expert used the lower, historical numbers, so he came out with a lower valuation figure. Under the income approach, Respondents' expert valued Kraus at between $5.9 million and $6.16 million.

Respondents' expert's valuation not only violated the industry standard, but it also defied logic. He valued Kraus at a lower figure than the amount loaned by the bank. That makes no sense. A bank would never lend more money to a company (up to several million dollars more) than the company is worth. Not surprisingly, Respondents offered no evidence to the contrary.

The lower court, however, rejected Magarik's expert's income approach valuation and credited Respondents' expert's income approach valuation. According to the lower court, Kraus' management's *own* projections were "never realized" and were "unrealistic projections, proven to be unrealized and wrong." R. 8-9. This was a crucial mistake by the lower court. The court applied the incorrect legal standard.

The court's job was to value Kraus as of the Valuation Date – not to look beyond that date and check to see if the projections were ultimately met or not. As a matter of law, the only date that mattered was the Valuation Date. And, as both experts agreed, the projections as of that date should have been used as long as they were realistic. So the question becomes: If projections prepared by a company's CFO, reviewed, relied on and certified by the company's shareholders, and submitted to a bank to obtain a multi-million dollar loan – under penalty of a federal felony – right before the Valuation Date, which the bank relied on to extend

a multi-million dollar loan are not realistic, then what is realistic? Respectfully, the lower court committed reversible error.

As mentioned, the other valuation approach used by both experts was the market approach. It is an accepted methodology in which the expert compares the subject company to other companies. Under this method, ratios are derived that allow companies of different sizes to be compared. As Magarik's expert explained at trial, the market approach is helpful to pick up factors such as a company's branding, and there was clear evidence at trial (including admissions by Respondents) that Kraus had developed strong branding as of the Valuation Date.

Under the market approach, Magarik's expert valued Kraus at $38,780,000 while Respondents' expert valued Kraus between $5.26 million and $6.1 million (again, even lower than the amount of the bank loan, which is absurd).

The lower court rejected Magarik's expert and credited Respondents' expert under the market approach. According to the lower court, it was wrong for Magarik's expert to compare Kraus to larger, public companies. R. 9 (lower court holding that Magarik's expert used "incorrect comparables, to wit, public companies, not reasonably relatable to Kraus either in terms of size, ownership or marketability"). The lower court apparently did not recognize that the whole purpose of the market approach and the ratios is to allow comparisons with bigger companies. It is an accepted practice in the valuation industry, which is not in

dispute, and there was no valid basis in the record to reject the comparables used by Magarik's expert. But, based on this mistake, the lower court just dismissed Magarik's expert's opinion under the market approach. This was also reversible error.

Magarik's expert averaged his valuations under the income and market approaches to arrive at an overall valuation of Kraus of $30,090,000. That is almost *identical* to the valuation Respondents themselves represented to the bank when they submitted their financial statements to the bank to get the loan. That is what they thought Kraus was worth when they wanted the loan and they certified that valuation to the bank – before this litigation and before they had an incentive to depress the valuation in order to buy Magarik out at a lower price.

This is not a case where the lower court simply decided between two experts and sided with the one found to be more credible. The lower court made legal errors, applying the wrong standards, to arrive at a decision that is contrary to the law and the evidence. This Court should reverse.

FACTS ESTABLISHED AT TRIAL

A. Kraus and its Shareholders

Kraus was founded in 2007. R. 20 (at ¶ 1). It is a sub-chapter "S" corporation for federal and state tax reporting purposes. R. 20 (at ¶ 3). At all relevant times, the Company had three shareholders: Levi (51% shareholder); Rukhlin (25% shareholder); and Magarik (24% shareholder). R. 20 (at ¶¶ 4, 5).

B. The Business of Kraus

Kraus is an importer and distributor of sinks, faucets and complementary plumbing fixtures and related accessories. R. 21 (at ¶ 9). The Company sells its products online through retailers. R. 21 (at ¶ 13).

C. Kraus' Rapid Growth

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. R. 466, 2409-2410. Both experts acknowledged Kraus' substantial growth prior to the Valuation Date.

Magarik's expert, Randall Paulikens, testified that Kraus showed "significant growth in sales over a very short period in an industry that is fairly stable …." R. 86. 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." R. 98 (emphasis added).

Likewise, Respondents' expert, Paul Marquez, agreed that Kraus' financial statements showed that Kraus' sales grew significantly in the years before the Valuation Date of September 20, 2015. R. 835-836. *See also* R. 1141 (Mr. Marquez's report) (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. R. 839-842.

As noted, the lower court also acknowledged Kraus' rapid growth. R. 7 (lower court describing Kraus as a "successful and growing business").

D. <u>Kraus Builds a Brand</u>

This issue is relevant because Mr. Paulikens testified that his market approach to valuation (discussed in detail below) sought to capture value that the income approach did not capture, which was associated with the fact that Kraus sold branded products, as opposed to unbranded ones.

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." R. 517-518.

b. Kraus placed its name and logo on its products, packaging and warranty information. R. 454.

c. Levi admitted that "Kraus is a brand." R. 445.

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". R. 535, 1855.

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." R. 2564.

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. R. 470-478, 533.

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." R. 632. The Company also had "a China team that was also part of the product development department because there was quite a bit done overseas." R. 648.

h. As mentioned, Kraus applied for a loan right before the Valuation Date. The lender was Bank Hapoalim, B.M. ("BHI"). Kraus represented to BHI 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*." R. 490, 2256, 2409 (emphasis added).

i. The Company further represented to BHI in June 2015 that "*Kraus is at the precipice of significant growth after years of building a recognized quality brand*." R. 495, 540, 2256, 2409 (emphasis added).

Kraus' brand recognition allowed it to sell its products in new ways that others in this established industry had not – through e-commerce distribution channels and positioning itself online. As Magarik testified, Kraus' visibility was superior to many of its competitors, including "companies that have been around for a very long time, considerably longer than Kraus." R. 524. He explained why: "In our case, we had penetrated the online industry at the time when he plumbing-home improvement industry was still focused on the traditional channels of distribution, such as brick and mortars and distributions where the products were on shelves." R. 542.

Discussing Kraus' online presence, Magarik further testified, "So when you actually landed on Faucet Direct, when you actually landed at Overstock, at Fixture Universe or E-faucets in the kitchen sink attribute, all you saw was Kraus

was polarizing and dominating first positions. You buy what you're seeing. And that is absolutely crucial to forming and actually continuing the brand." R. 526.

Kraus also promoted its brand through online advertising, including banners on websites, which Magarik explained at trial: "[I]f you're looking for a faucet or sink, you would go on [the home page] and at the top or on the sides you will have banners with Kraus imagery and … Kraus plastered everywhere, which actually creates brand recognition and trigger for a client to purchase that specific brand that is being advertised." R. 529.

All of the branding and innovative ideas were working as of the Valuation Date. As Magarik testified, "We had a niche, which was online. We were extraordinarily successful at it. It's one of the reasons that the company went from zero to 36 million … [T]hat is a success story in such a short period of time in that mature industry." R. 595. All of the foregoing testimony was unrebutted.

E. The BHI Loan, Management's Projections, and Respondents' Own Certified Valuations

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"). R. 22 (at ¶¶ 20-21).

In July 2015, Kraus refinanced the Chase and Fertipham debt by entering into a revolving credit note with 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. R. 22 (at ¶ 22).

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." R. 22 (at ¶ 23). Those documents were admitted into evidence at trial as Exhibit 58. R. 22 (at ¶ 24), 2140-2367.

i. Management's Projections

As discussed, one of the documents that Kraus provided to BHI was management's projections of the Company's future performance, dated June 8, 2015 (mere months before the Valuation Date). R. 1873-1878, 2280-2285. The projections estimated Kraus' revenues for the period through 2015 and for 2016. *Id.*

The projections were prepared by the Company's chief financial officer, Daniel Lusby, who has been a licensed certified public accountant since 2002, and served as the controller of a number of companies before joining Kraus. R. 972, 984-985, 987.

Mr. Lusby, on Kraus' behalf, confirmed the reasonableness of the projections. Indeed, the Loan and Security Agreement itself 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 [i.e., Kraus'] judgment based on present circumstances of the most likely set of conditions and course of action for the projected period*." R. 1938 (§ 5.5(b)) (emphasis added).

Mr. Lusby testified that he reviewed this provision, Section 5.5(b) of the Loan and Security Agreement, before Kraus signed it. R. 988.

In addition, 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. R. 2606-2609. 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.*; R. 992. Mr. Lusby replied by email as follows: "Serge, I am fully aware of all these requirements/representations. I confirm and acknowledge them." R. 2606. *See also* R. 992.

ii. Respondents' Own Estimates of Kraus' Value

As part of the due diligence process, BHI also asked for and received personal financial statements from all three shareholders (Magarik, Rukhlin and Levi). R. 2463-2465 (Magarik's personal financial statement); R. 2466-2468 (Levi's personal financial statement); and R. 2469-2471 (Rukhlin's personal financial statement).

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.

R. 2467, 2470.

In his personal statement, Rukhlin valued his 25% interest in Kraus at $7.5 million. R. 434, 2469. That equates to a valuation of Kraus, as a whole, of $30 million. *Id.*

Similarly, in his personal statement, Levi valued his 51% interest in Kraus at $15.3 million. R. 499, 2466. That equates to a valuation of Kraus, as a whole, of a little more than $30 million. *Id.*

Importantly, those valuations of Kraus by Respondents themselves are nearly identical to Magarik's expert's valuation of Kraus -- $30,090,000.

Respondents stood by those valuations. 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. R. 432, 497. 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. R. 433.

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. R. 23 (at ¶ 29).

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." R. 112 (emphasis added).

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 $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*.

R. 70-71 (emphasis added).

Respondents accepted the loan from BHI and never told BHI that Kraus' own projections or Respondents' valuations of their interests in Kraus were exaggerated even slightly.

PROCEDURAL HISTORY

The Petition in this case was filed on September 21, 2015. R. 2624-2643. It contained several causes of action against Respondents, including for breach of contract, breach of fiduciary duty, waste, conversion and fraud. *Id*. By stipulation dated July 26, 2018, all claims but the first cause of action, for dissolution of Kraus, were withdrawn. Additionally, Respondents had asserted a counterclaim

against Magarik for breach of fiduciary duty. R. 2644-2650. By stipulation dated November 30, 2017, the counterclaim was withdrawn.

Pursuant to Section 1118(a) of the Business Corporation Law, Respondents elected to purchase Magarik's 24% ownership interest in Kraus. R. 2651-2652. Accordingly, the only issue to be determined in this matter is the value of Magarik's 24% ownership interest in Kraus as of the Valuation Date (i.e., September 20, 2015, the day before the Petition was filed).

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. R. 25-1068.

On April 10, 2020, the lower court issued a Decision and Order After Trial (as subsequently modified on May 14, 2020, the "Decision"). R. 6-14. In the Decision (which was only six pages long), the lower court held that the fair market value of Kraus as of the Valuation Date was only $6.05 million and that Magarik's 24% interest was valued at $1,379,400. R. 6-11. According to the lower court's Decision, the projections that Mr. Paulikens relied on – the same projections that Respondents submitted to BHI to get the loan, and the same projections that Respondents themselves certified were correct – "were proven to be unrealized and wrong." R. 9.

A Judgment was entered on May 26, 2020. R. 15-19. This appeal followed. R. 1-5.

LEGAL ARGUMENT

THE LOWER COURT'S VALUATION OF MAGARIK'S INTEREST IN KRAUS WAS ERRONEOUS

A. Legal Standards

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.

BCL § 1118(a).

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.

BCL § 1118(b).

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. County 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*.

"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).

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. 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*.

"Since this case was tried by the court without a jury, the authority of this Court to review findings of fact is as broad as that of the trial court and includes the power to render the judgment it finds warranted by the facts, taking into account in a close case that the trial judge had the advantage of seeing the witnesses." *Matter of Murphy v. U.S. Dredging Corp.*, 74 A.D.3d 815, 817 (2d Dep't 2010) (reversing trial court's valuation).

B. <u>The Valuation Methodologies</u>

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

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." R. 115.

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

Both methodologies (the income approach and the market approach) are accepted in the business valuation industry. Both experts' valuations are discussed below. The lower court's failure to adopt Mr. Paulikens' valuations was contrary to the law and the evidence.

C. Mr. Paulikens' Income Approach Was Proper

Mr. Paulikens' income approach, utilizing a discounted cash flow methodology, 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 did not use those projections and, instead, used Kraus' historical data. That was the main difference in their income approaches, and the evidence showed that Mr. Paulikens' approach was more sound.

The use of the projections Kraus provided to BHI is appropriate here because Kraus was experiencing tremendous growth. 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.

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." R. 87. 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." R. 70.

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 (which appears on his website), 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.

R. 848-849, 2577 (emphasis added).

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". R. 854. Mr. Marquez substituted his own judgment for the judgment of both BHI and Kraus' own management.

Tellingly, a colleague that Mr. Marquez respects and trusts authored an article disagreeing with the approach Mr. Marquez used here. 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). R. 853. Mr. Marquez admitted that he respected Mr. Rudman and trusted his opinion – otherwise, he would not have asked Mr. Rudman for a peer review. R. 853-854.

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*.

R. 855-856 (emphasis added).

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.

R. 856-857 (emphasis added). That is exactly what happened here – Kraus' management prepared the projections and submitted them to BHI to raise capital through the line of credit.

Mr. Marquez testified that he agreed with the statements read into the record from Mr. Rudman's article. R. 855, 857.

Since Mr. Marquez himself believes that projections should be used as long as they are realistic, his failure to use Kraus' projections could only be justified if those projections were unrealistic. *But not a single witness thought the projections were unrealistic at the time*.

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 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; the loan agreement itself stated that the projections were reasonable and reflected Kraus' "judgment based on present circumstances of the most likely set of conditions and course of action for the projected period; and, 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.

All of this evidence confirmed that the projections were realistic, and there was no proof to the contrary. As a result, in accordance with the industry standard for a growing company like Kraus, Mr. Paulikens properly used the projections in his income approach valuation. Under the income approach, Mr. Paulikens valued Kraus at $21,390,000 as of the Valuation Date.[2] Accordingly, if this Court adopts Mr. Paulikens' income approach valuation, then the price for Magarik's shares (his 24% interest) is $5,133,600 (plus interest from September 21, 2015).

On the other hand, Mr. Marquez's income approach was fatally flawed. The main problem 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

[2] The income approach valuation of Kraus in Mr. Paulikens' expert report (R. 1078-1136) was $19,647,000 but it contained a mathematical error, which Mr. Paulikens explained at trial without objection. R. 148.

extend the loan. Mr. Marquez testified at trial that he did not use the projections because they were not ultimately met – *he admitted that he was using hindsight, which is not allowed*. R. 789, 795-796 (Mr. Marquez stating that the projections were not reliable because the projections for 2015 were not realized).

That was improper. The valuation must be done *as of the Valuation Date*. The issue is what the marketplace knew at that time, how the marketplace viewed Kraus at that time, and what the marketplace would pay for Kraus at that time. As Mr. Marquez acknowledged, as long as the projections were realistic at that time, they should have been used. As mentioned, he wrote in his own website article, "Projected earnings, therefore, is my answer to which earnings figures to use." R. 2577. Mr. Marquez, however, did not follow that approach here even though all of the evidence – the testimony from every fact witness, the documents (including Respondents' own projections, financial statements, email correspondence and loan agreement with BHI) and the actions of BHI, an actual lender in the marketplace who received, considered and relied on the projections in deciding to extend the loan – showed that the projections were realistic as of the Valuation Date (the only date that mattered), and there was no evidence to the contrary.

This was Mr. Marquez's key mistake, and the lower court erred by adopting it. Looking back on how things eventually panned out over time – to see whether the projections came true or not – is not the legal standard. Again, what matters is

whether the projections were realistic as of the Valuation Date. The case law is clear on this point. *See*, *e.g.*, *Matter of Murphy*, 74 A.D.3d at 818 (trial court committed reversible error when it "improperly considered a liability for pensions awarded to the Corporation's officers pursuant to a resolution dated March 29, 2006, after the valuation date of February 13, 2006"); *Miller Bros. Indus. v. Lazy River Inv. Co.*, 272 A.D.2d 166, 167-68 (1st Dep't 2000) ("We reject the dissenting shareholders' argument that investment value as of the valuation date may be computed retrospectively based on the corporation's reported actual earnings for the fiscal year ending eleven months after the valuation date, since fair value may include elements of future value only if known or susceptible of proof as of the date of the merger and not the product of speculation.") (internal quotation marks and citation omitted).

It appears that Mr. Marquez did not follow the correct methodology (to use the projections) because he was purposely trying to keep the valuation down for his clients. Whatever his motives were, he used the wrong numbers, in violation of the standard he previously endorsed.

Mr. Marquez valued Kraus at $6.16 million under his income approach. R. 1157. Because he used a less reliable method, Mr. Marquez's valuation of Kraus was unreasonably low. In fact, Mr. Marquez's valuation figure is less than the amount of the credit facility extended by BHI (up to $7-10 million). *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. R. 875.

It defies common sense to 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. As discussed, BHI, as a market participant, was performing the same type of analysis that the Court is now engaging in – to determine what Kraus was worth in 2015. BHI lent the money to Kraus expecting to be paid back in the future, so BHI had to be confident in Kraus' financial health going forward, through the term of the loan. It would not have made any sense for BHI to lend Kraus up to $7 million to $10 million if the market thought that Kraus was worth only $6.16 million as Mr. Marquez would have this Court believe.

D. <u>The Market-Based Valuation Approach</u>

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.

Mr. Paulikens explained why he incorporated the market-based approach into his valuation analysis, in addition to the income approach: "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." R. 171. These are important factors that the market considers, and Mr. Paulikens wanted to make sure these aspects were picked up in the valuation.

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." R. 150. Both of these methods are accepted in the valuation industry.

Mr. Paulikens used the public company approach. Mr. Marquez used the private company approach. The approach used by Mr. Paulikens was more reasonable, and it appears that the lower court did not credit how this approach works.

i. Mr. Paulikens' Market Approach Was Proper

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." R. 152. "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.*

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." R. 153.

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." R. 164.

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. R. 167. 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. R. 167, 245-246. In his judgment, Mr. Paulikens felt a 10% discount was appropriate under the circumstances. *Id.*

Mr. Paulikens then applied the resulting ratio to Kraus' year-end 2015 financial results. There was nothing wrong with that. 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. We also note that if Mr. Paulikens had applied his ratio to the projected revenue figure for 2015 submitted to BHI, his valuation would have been higher. R. 168.

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. R. 145, 1114. Accordingly, if this Court adopts Mr. Paulikens'

market approach valuation, then the price for Magarik's shares (his 24% interest) is $9,309,600 (plus interest from September 21, 2015).

At trial, Respondents did not dispute that the public company comparison method is an accepted valuation approach. Nor did they dispute that Capital IQ is an accepted, reliable database of information that experts routinely use and rely on to conduct market-based valuations. Instead, Respondents' main issue with Mr. Paulikens' approach was that Mr. Paulikens compared Kraus to much larger companies. This was an odd criticism. The whole purpose of the ratios that are derived in the market approach is to compare companies of different sizes. That is what allows a small, private company to be compared with a large, public company.

Mr. Paulikens explained this at trial. R. 163 (ratios permit comparisons with companies that are "much larger, billions of dollars of sales, thousands of employees …"). Of course the public company is going to have many more employees and much higher revenues. The ratios account for that. In addition to higher revenues, those large public companies will also have much higher equity and debt numbers. Those are the elements of the ratio and they allow an apples-to-apples comparison. Mr. Paulikens properly used this approach and compared Kraus to other companies with similar attributes (what they sell, how they sell, etc.). As discussed below, Mr. Marquez did not.

ii. Mr. Marquez's Market Approach Was Not Reasonable

Mr. Marquez used the private company comparison method in his market-based approach. He reviewed information from Pratt's Stats, a database for private company transactions. R. 726.

Pratt's Stats has some inherent limitations that are relevant here. Despite using Pratt's Stats, Mr. Marquez acknowledged such limitations. R. 901.

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). R. 901. And, unlike public company transactions, the information in Pratt's Stats is not vetted by the SEC. R. 282. As a result, according to Mr. Paulikens, "you have no definitive reliance that the numbers are even accurate." *Id.*

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. R. 904.

Since Kraus was a growing company in September 2015, these limitations in Pratt's Stats are important and limit the usefulness of that approach. R. 283. Yet, even though Mr. Marquez acknowledged that Kraus' revenue was "growing at an

outstanding rate" (R. 672), he still used Pratt's Stats in his market-based approach (R. 726).

The companies that Mr. Marquez selected from Pratt's Stats were *completely dissimilar 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. R. 922-926.

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. The companies picked by Mr. Marquez are not like Kraus at all. Yet, incredibly, when the lower court mentioned the market approach in its Decision, the lower court held that it was Mr. Paulikens who based his market approach on "incorrect comparables". R. 9. The lower court got it exactly backward.

Under Mr. Marquez's market approach, he valued Kraus at between $5.3 million and $6.1 million. R. 1161. As with Mr. Marquez's income approach valuation, his market approach valuation is unreasonably low.

Again, 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). As discussed, it defies logic to 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. The lower court's adoption of Mr. Marquez's unreasonably low valuation is reversible error.

E. Magarik's Interest Should Have Been Valued at $7,221,600

Mr. Paulikens took the average of his valuation of Kraus under the income approach ($21,390,000) and his valuation of Kraus under the market approach ($38,790,000) to arrive at a valuation of the Company of $30,090,000 as of the Valuation Date. As discussed, that valuation is very close to the $30 million valuation of the Company that Respondents themselves represented in their personal financial statements submitted to BHI – subject to criminal penalties – to induce BHI to lend the Company money shortly before the Valuation Date.

Using that valuation of Kraus, Magarik's 24% interest in Kraus should be valued at $7,221,600 (i.e., 24% of $30,090,000), plus interest from September 21, 2015.

F. The Lower Court Used the Wrong Legal Standard

As discussed, pursuant to BCL § 1118(b), a court must "determine the fair value of the petitioner's shares as of the day prior to the date on which such petition was filed." BCL § 1118(b). Thus, the lower court was required to assess the value of Kraus as it existed on September 20, 2015. It is immaterial what the Company was or is worth on any other day.

For example, if the economy unexpectedly collapsed on September 21, 2015 (or any day thereafter) and the value of the Company plummeted, that would not matter. Conversely, if the value of the Company unexpectedly skyrocketed on September 21, 2015 (or any day thereafter), that would not matter. The only thing that matters is what the marketplace knew *as of the Valuation Date* and how the marketplace valued Kraus *as of the Valuation Date*. Hindsight is not permitted.

This was the main flaw in the lower court's decision concerning the income approach. As discussed, according to both experts, the court should have used the Company's projections as long as they were realistic as of the Valuation Date. The test is not whether those projections ultimately came true. The test is whether, at the time, they were realistic. As set forth at length above, all of the evidence

established that the projections were indeed realistic. Again, the projections were: prepared by the Company's CFO (who separately confirmed to Magarik by email that he understood and appreciated that the information provided to BHI needed to be correct); reviewed and agreed to by Respondents (along with Respondents' financial statements in which they certified their valuations of the Company); submitted to BHI under the penalty of a federal crime if the projections were knowingly false; considered and relied on by BHI in deciding to extend the loan; and referenced in the loan agreement as being reasonable and accurate. *And all of that happened right before the Valuation Date*. If that is not realistic, it is hard to fathom what is.

As discussed above, however, in connection with the income approach, the lower court rejected the Company's own projections and Respondents' own certifications of the value of the Company – submitted to BHI to get the loan right before the Valuation Date – because those figures "were proven to be unrealized and wrong." R. 9. The lower court chose to go beyond the Valuation Date to see if the projections came true or not. That was improper.

Events that occur after the valuation date are irrelevant (unless they were known and predicted on the valuation date), and it is reversible error for courts to consider future events retrospectively when assessing a corporation's value. *See*, *e.g.*, *Matter of Murphy*, 74 A.D.3d at 818 (trial court committed reversible error

when it "improperly considered a liability for pensions awarded to the Corporation's officers pursuant to a resolution dated March 29, 2006, after the valuation date of February 13, 2006"); *Miller Bros.*, 272 A.D.2d at 167-68 ("We reject the dissenting shareholders' argument that investment value as of the valuation date may be computed retrospectively based on the corporation's reported actual earnings for the fiscal year ending eleven months after the valuation date, since fair value may include elements of future value only if known or susceptible of proof as of the date of the merger and not the product of speculation.") (internal quotation marks and citation omitted).

This was a critical mistake. The lower court clearly got the income approach wrong, and this Court should reverse. Indeed, if the lower court's decision is allowed to stand, it will completely change the law in New York. Instead of valuing a company as of the valuation date, the new test will be to value the company with the benefit of hindsight, to see how the facts eventually turned out – years down the road – and then base the valuation on what is known now, as opposed to what was known on the valuation date. That would be new law and a terrible precedent.

The lower court then compounded its mistake with respect to the income approach by adopting Respondents' expert's market approach. The whole point of that approach is to allow comparisons of companies of different sizes. The lower

court missed this point, and faulted Magarik's expert for comparing Kraus to bigger, public companies – despite the fact that the public company approach is an accepted methodology. That too was reversible error.

All of this resulted in an absurd outcome. According to Respondents' expert, Kraus was worth less money (millions of dollars less) than the amount of the BHI loan! That just cannot be the case. A bank only lends money when it expects to be repaid in full. Yet, according to the lower court, BHI was willing to lend Kraus between $7 million and $10 million even though Kraus was only worth $6.05 million. That is simply illogical, and the reason the lower court made that determination is because it failed to follow the evidence and the law.

Magarik respectfully requests that this Court reverse.

CONCLUSION

For all of these reasons, we respectfully request that the lower court's Decision and Judgment be reversed as set forth herein.

Dated: Uniondale, New York
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Respectfully submitted,

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