SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

In the Matter of the Application of: GURNEY'S INN RESORT & SPA, LTD., a New York corporation, Petitioner, and NANCY ARZANIPOUR, PAUL ARZANIPOUR, ANTHONY CARBONE, NEIL CARBONE, KEVIN COTTER, DOLLY WANDER IRREVOCABLE TRUST, LORRAINE FERRETTI, PATRICIA FRANK-JANEWICZ, GEORGE ROSENFELD INC., MICHAEL GIORDANO, JANICE KATZ, CHRISTINE LAURIA, NEIL CARBONE REVOCABLE TRUST, MARCIA RUSKIN, JAY SCANSAROLI, JANICE SCANSAROLI, JOSEPH SCOGNAMIGLIO, ALAN SPARKS, SYSTEMATIC CONTROL CORP. and VITO VITRANO Respondents, To Determine the Fair Value of the Common Shares of Gurney's Inn Resort & Spa, Ltd. Held by Respondents Pursuant to Section 623 of the New York Business Corporation Law.	Index No.: 154466/2018 (Hon. Barry R. Ostrager)

PETITIONER'S POST-HEARING MEMORANDUM

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Petitioner Gurney's Inn Resort & Spa, Ltd. ("Gurney's") hereby submits its post-hearing memorandum demonstrating that it has offered fair value for Respondents' shares.

PRELIMINARY STATEMENT

On March 29, 2018, to effectuate the buyout of the minority shareholders contemplated under the MOU (signed in 2013 and approved by a supermajority of those shareholders), Gurney's effected a merger transaction and made a tender offer of $118.81 per share (the "Tender Price") to the minority shareholders. As discussed in Gurney's pretrial memorandum, the Tender Price was calculated by applying an allocation formula set forth in the MOU to an appraised value determined by CBRE (the firm selected by Gurney's with the approval of the minority shareholders' board representative).[1] In a BCL valuation proceeding, however, fair value is based on an equal pro-rata allocation of net value (after deducting mortgage debt) among all shareholders. Thus, CBRE's valuation of $84 million corresponds to a fair value of $94.93 per share,[2] and by electing to invoke their BCL 623 remedy rather than abide by the MOU, Respondents rejected a Tender Price that was 25% ***above*** fair value.

As described below, the HVS appraisal offered by Respondents is result-oriented, and rife with conceptual, factual and mathematical errors in its income capitalization approach that render its conclusions unreliable. The two primary errors discussed herein – inflating rooms revenue by at least $800,000 and underestimating the cost of generating that revenue by another $855,000 – combine to inflate base year net income "EBITDA" by $1.65 million (accounting for 26.6%, or $30 million, of HVS' estimated $115 million value).[3] Yet even were the Court to

[1] Although the minority shareholders only held 16.36% of the total Class A shares, they were entitled under the MOU formula to 26.44% of the appraised value over $50 million, thus allocating to the minority shareholders more than their pro-rata share of the appraised value.

[2] ($84,000,000 unencumbered value - $21,543,861 mortgage) ÷ 657,900 shares = $94.93. The total number of Class A shares is not disputed. In a complaint filed in federal court on March 27, 2018, respondent Alan Sparks confirmed that "[a]s of January 2010, there were approximately 657,900 shares of Gurney's Class A stock . . . ." *See* Case 2:18-cv-01856, Document No. 1 at 5, ¶ 5(a). Notably, Gurney's is *not* asking the Court to award less than $118.81 per share.

[3] ($800,000 + $855,000) ÷ 6,228,000 HVS projected 2018 EBITDA (HVS Appraisal at 127) = 26.6%.

adopt HVS' valuation entirely, Respondent's shares would have a fair value of $142.05 per share.[4] The Tender Price is therefore a mere 16% lower than the *maximum fair value that the Court could possibly adopt in this case based on the competing appraisals* presented to it.

ARGUMENT

RESPONDENTS ARE TO RECEIVE A PRO-RATA ALLOCATION OF GURNEY'S VALUE AFTER SATISFACTION OF MORTGAGE DEBT

Under BCL 623, fair value of minority shares is the minority shareholder's proportionate interest in the value of the entire company. *See In the Matter of Selma K. Friedman v. Beway Realty Corp.*, 87 N.Y.2d 161, 168-69 (1995) ("fair value [is] calculated on the basis of petitioners' proportionate share of all outstanding corporate stock"); *In the Matter of the Dissolution of Seagroatt Floral Company, Inc.*, 78 N.Y.2d 439, 443 (1991) (fair value process ascribed value to company and then divided by "the total number of common shares . . . to obtain a per-share value"). Insofar as Respondents rejected the MOU valuation methodology and elected to pursue a remedy under BCL 623, the fair value of their shares must be based on their proportionate interest in Gurney's 657,900 shares rather than the allocation formula set forth in the MOU.[5]

In *In the Matter of Pace Photographers, Ltd.*, 71 N.Y.2d 737 (1988), the Court of Appeals held that valuation methodologies set forth in a shareholder agreement are inapplicable in statutory valuation proceedings, unless the agreement expressly provides that it is to apply. In *Pace Photographers*, there was a shareholder agreement that ascribed a set value to the respective majority and minority interests and provided that such value would apply to a voluntary sale between shareholders. *Id.* In the context of a valuation proceeding pursuant to

[4] ($115,000,000 unencumbered value - $21,543,861 mortgage) ÷ 657,900 shares = $142.05.

[5] The MOU provided that (a) an appraisal would be conducted with the approval of the minority shareholders' representative on the board and (b) the favorable allocation formula would be applied to *that appraisal*. (*See* MOU [Exhibit A to the Petition] at 9-10.) Neither the majority shareholder buying Gurney's nor the minority shareholders who were being bought out had the right to insist on a second appraisal if they disagreed with the one obtained pursuant to the MOU, but that is exactly what Respondents are attempting. This court should not re-write the MOU by giving either of them that right under the guise of a BCL 623 fair value determination.

BCL 1118 (where a majority owner elects to buy out the minority owners rather than dissolve the company), the majority shareholder argued that the value established by the shareholder agreement must be the fair value of the minority interests. The Court of Appeals held that unless the shareholder agreement expressly stated that the agreed value would apply in a judicial fair value proceeding or that a sale pursuant to the BCL would be deemed voluntary, it would be error to adopt the shareholder agreement's value rather than conduct an independent investigation into the company's fair value. *Id.* at 748. *See also Matter of Penapent Corp.*, 96 N.Y.2d 186 (2001) (rejecting argument that contractual valuation terms applied in a BCL 1118 valuation proceeding); *Matter of Sands Point Land Co. v. Rossmoore*, 43 Misc.2d 368, 371 (Sup. Ct. Nassau Cnty. 1964) (rejecting shareholder agreement to sell shares back to corporation at par value; where shareholder has right to valuation under BCL 623, fair value rather than contract value is the benchmark; to hold otherwise "would nullify the provisions of section 623").

Here, the MOU does not, either expressly or by implication, indicate that its disproportionate value allocation formula applies if the minority shareholders *reject* the MOU in favor of seeking a judicial fair value determination under BCL 623. Indeed, Respondents' rejection of the CBRE appraisal is a rejection of the MOU's methodology for compensating minority shareholders for the loss of their shares. The Court, therefore, should implement the pro-rata allocation method held appropriate in BCL 623 proceedings.[6]

[6] It cannot be disputed that the allocation must be made only after deducting mortgage debt from the unencumbered value estimated by the competing appraisals. Fair value is based on what a willing buyer would pay for an asset. *Beway Realty Corp.*, 87 N.Y.2d at 168. No buyer would pay the unencumbered value to buy an encumbered asset. Either the price must be reduced to induce the buyer to assume the debt or the debt must be paid from sale proceeds. In either event, the shareholders will receive only the net amount after deducting the mortgage. The MOU (Docket No. 3) acknowledged the existence of significant mortgage debt (*see* pages 5-6). Respondents admit that the mortgage debt must be deducted from gross value to arrive at a fair value. *See, e.g.*, Verified Answer ¶¶ 1, 2, 18 [arguing that fair value "after satisfaction of all projected debt and equity contributions" is higher than CBRE appraisal]. Respondents also attached as Exhibit R to their Verified Answer (Docket No. 41) Gurney's 2017 unaudited financial statement, indicating an end-of-year mortgage balance of $21,543,861.03.

THE HVS APPRAISAL CONTAINS MATERIAL ERRORS, RESULTING IN AN OVERESTIMATION OF GURNEY'S ROOMS REVENUE AND HENCE ITS VALUE

The Uniform Standards of Professional Appraisal Practice ("USPAP") warn that because the discounted cash flow valuation method "is dependent on the analysis of uncertain future events, it is vulnerable to misuse or misapplication." USPAP Advisory Opinion 33. "[E]ven slight input errors can be magnified and can produce unreasonable results." *Id.* Thus, "it is the responsibility of the appraiser to ensure that the controlling input is consistent with market evidence . . . [and] to make rational and supportable assumptions." *Id*. "The results of DCF analysis should be tested and checked for errors and reasonableness." *Id*. As described herein, HVS disregarded these warnings, as it made assumptions contrary to market evidence, others that were irrational and unsupportable, and, when (predictably) its resulting projections differed materially from actual observed performance, HVS failed to test and check its results for error.

One of the HVS appraisers who prepared Respondents' expert report, Erich Baum, confirmed at the hearing that the primary value-driving difference between the CBRE appraisal and the HVS appraisal is their respective projections of rooms revenue, and specifically the increase in revenue that was expected to result from the market rental of hotel rooms previously occupied by timeshare owners ("TSOs") in 2017.[7] (Tr. at 158 and 154.) Mr. Baum testified that to project this additional income required him to "scrub out" the effects of TSO occupancy (Tr. at 140) by assuming that TSO-occupied units would generate the same annual average daily rental rates ("ADR") as the other rooms. (*Id.* at 143.)

The Court plainly understood that this exercise should be straight forward, as it attempted to confirm that Mr. Baum "just applied the same revenue that was generated from the non-TSO to the TSO, correct?" (Tr. at 159). Although Mr. Baum seemed to confirm the Court's observation (*id.*), that is *not* in fact what the HVS appraisal accomplishes (not by a long shot).

[7] Mr. Baum conceded that: (a) HVS and CBRE used "virtually identical" methodologies (Tr. at 153) and (b) there was no meaningful difference between capitalization and discount rates chosen by HVS and CBRE. (*Id.* at 155-58.)

Through what it called a "normalization" process applied to actual 2017 performance statistics, HVS simply created a fictional, highly inflated, ADR, and then applied it to the 5,273 TSO-occupied rooms that were added to Gurney's rental pool. The fictional ADR was significantly *higher* than actual ADR for the more than 7,085 ***identical*** TSO room nights that were rented at free market rates in 2017, rendering HVS' estimated incorrect and its conclusions highly misleading. (Compare HVS Appraisal at 106 [$994.52 "normalized" annual ADR for TSO rooms], with Gurney's Exh. 4 [as confirmed by Mr. Baum (Tr. at 204), actual ADR for TSO rented rooms in 2017 was $728.75].)

Although ignored by HVS, the following simple adjustments fully account for the impact that abandoning timeshare ownership would have had on gross rooms revenue in 2017:

First: determine the rooms revenue actually earned by Gurney's from all sources in 2017, namely (i) maintenance received from all timeshare owners, (ii) rental income received from rental of sponsor-owned room nights and (iii) rental income received from rental of timeshare owned units;

Second: deduct from that number the maintenance payments received in 2017 (as they would not have been paid if Gurney's was not a cooperative);

Third: add in the projected revenue from renting 5,273 TSO-occupied room nights at the same ADR as the 7,085 TSO room nights (i.e. over 60% of all TSO room nights) that *were* rented in 2017.

As demonstrated during the hearing, applying this simple methodology, and utilizing actual ADRs rather than HVS' fictitious "normalized" numbers, had Gurney's not been a cooperative in 2017, it would have *lost* $3.5 million in maintenance, *gained* $3.8 million by adding 5,273 owner occupied room nights to its rental pool, and earned a total of $15,357,000 in rooms revenue in 2017.[8] (Tr. at 211-13.) CBRE conducted an analysis of the actual performance of Gurney's for the 12-month period ending in August 2018 (Gurney's Exh. 5; Tr.

[8] In addition to this addition to gross rooms revenue, Gurney's also gained from de-cooping by not having to pay TSOs who rented their units 60% of the rental income. In 2017, de-cooping would have added over $31million to Gurney's *net* rooms revenue. (HVS Appraisal at 119.) The total gain, however, is still well below the $4.6 million benefit projected by HVS.

at 68), that showed actual rooms revenue for that period was $15,769,591, only 2.6% higher than the revenue that the foregoing simple analysis determined would have been earned in 2017 had all rooms been on the rental market. (Inflationary growth of about 3% was consistent with expectations.)

Mr. Baum admitted that this simple methodology and the specific calculations used to implement it were sound. *See* Tr. at 197 (total rooms revenue is comprised of maintenance and rents); at 209 (the 109 Gurney's rooms generated $15,023,904 in 2017); at 209-10 (maintenance payments in 2017 totaled $3.5 million); at 199-203 (the 5,273 TSO-occupied room nights that were not on the rental market in 2017 were identical in all relevant ways to the 7,085 TSO room nights that were already in Gurney's rental pool in 2017 and should perform the same, economically.[9]) Mr. Baum not only admitted, but calculated on the witness stand, that the ADR for the 7,085 TSO room nights that had been rented in 2017 was $728.75 (and that even at the height of the rental season, ADR for such rooms was $978.65). (Tr. at 204.) Mr. Baum was asked if he could find a flaw in the foregoing methodology, and, unable to do so, conceded that "it probably is" correct. (*Id*. at 209.)

By contrast to this simple deductive analysis, driven by actual data, HVS' "normalization" process was based on a host of unreasonable assumptions and math fabrications. By that process, HVS concluded that (a) the 5,273 TSO units that would have been added to the rental pool in 2017 would have rented at an annual overall ADR of $994.52 (*see* HVS appraisal at 106 and 107), ***36.5% higher than the $728.75 ADR actually experienced by the identical 7,085 TSO units rented at market rates in 2017*** and (b) de-cooping would have added $4.6 million (as opposed to $3.8 million predicted by management) to Gurney's rooms revenue in

[9] The Court noted that Mr. Baum testified that he "would expect that the economic performance of the 5,000 rooms that we're assuming would be put on the market in 2017, would be the same as the 7,000 that were already on the market." (Tr. at 203.)

2017.[10] (*See* HVS Appraisal at 109 ["Overall, the budget implies the capture of $3.754 million in revenue previously lost to unpaid timeshare occupancy. In comparison, our analysis indicates that approximately $4.635 million was foregone."]) This $800,000 overstatement of rooms revenue is the plain result of unreasonable assumptions and incorrect "normalization" or made-up math. It is entirely irrational to assume that customers who paid, on average, $729.75 per room would somehow be willing to pay $266 *more* to rent concededly *identical* rooms. HVS' conclusion is clearly flawed. The most cogent illustration of that flaw is that HVS' "normalized" ADR for August was $1,309, but Mr. Baum personally confirmed by calculating on the stand that actual ADR of TSO rented units for that month was $978.65. Thus, during the height of the season, when the greatest number of TSO rooms would be rented, Mr. Baum's "normalized" ADR exceeded actual observed performance of identical rooms by 34%.

HVS compounded its $800,000 "normalization" error by applying a 6% growth rate to project an aggressive $17.1 million in rooms revenue in base year 2018 (*see* HVS Appraisal at 127), more than $2 million over actual rooms revenue in 2017 and more than $1.8 million higher than management predicted for 2018. (*See* CBRE Appraisal at 86.) HVS also projected that annual ADR for 2018 would rise from $577 to $673.10, far higher than the ADRs of comparable hotels on eastern Long Island. (HVS Appraisal at 109, 127; CBRE Appraisal at 78[11].)

Not only is the "normalization" process employed by HVS conceptually mistaken, it is also rife with mathematical errors. For example, HVS (a) derives revenue from all rooms, including the 5,273 TSO rooms that were not rented in 2017, but then (b) divides the resulting inflated revenue figure by only those rooms that had been rented to paying guests. As a result, HVS falsely forecasts that adding 5,273 market based room nights would have somehow

[10] HVS' assertion that TSO room nights were highly concentrated in the Summer months, and would therefore add more revenue than the sponsor-owned units does not account for HVS' projected 40% increase in ADR *relative to the 60% of TSO room nights that were already in the rental pool*. The 5,273 rooms occupied by TSOs in 2017 were identical in their distribution throughout the year to the 7,085 that were in the rental pool. (Gurney's Exh. 4.)
[11] The annual ADR for Gurney's and its main competitors averaged $465.49.

increased annual ADR for the entire resort to $635 in 2017 (with Summer month ADRs as high as $1,390). This process is described between Figure 6-2 on page 100 of the HVS Appraisal and Figure 6-9 on page 107. Yet Figure 6-2, ***the basis for all subsequent adjustments and forecasts***, is mathematically wrong.[12]

Making matters worse, HVS had available to it actual performance data through August 2018 (i.e., including the Summer months that it contended were most significant to its normalization). That data showed that its projections were seriously flawed; but by contrast, CBRE (and Gurney's management) made far more accurate projections. Rooms revenue for the trailing 12-month period ending on August 31 was $15,769,591 (within 3% of management's prediction 3.6% of CBRE's projection for 2018) and ADR for that period was $618.32 (within 2% of CBRE's projection of $605.90 for 2018). (*See* CBRE Appraisal at 86, 110.) HVS' projections of both ADR and rooms revenue, by contrast, 9% higher than actual performance. USPAP advises appraisers to reconsider their analyses and assumptions where, as here, actual data does not comport with projections in a retrospective appraisal. *See* USPAP Advisory Opinion 34. HVS simply ignored the large disparity between actual performance and its projections.

Inflating rooms revenue is not HVS' only error. For example, HVS is overly aggressive in predicting that rooms expenses would stabilize at only 23.7% of rooms revenue in 2019. (HVS Appraisal at 127 and 128.) Historically, Gurney's rooms expenses far exceeded 30% of rooms revenue and industry publications reported that other segments of the hospitality industry reported rooms expenses between 25% and 30% of rooms revenues. *See* CBRE Appraisal at 87.

[12] HVS calculated total rooms revenue for 2017 by multiplying all occupied rooms (even those that were occupied by non-rent paying timeshare owners) by the reported ADR for *rented rooms*. The resulting $15.5 million revenue calculated by HVS is $500,000 above actual reported rooms revenue. (HVS Appraisal at 98.) By coincidence, that number was within $40,000 of total rooms revenue reported *for Gurney's and Panoramic, combined*. As Mr. Baum testified, HVS assumed (mistakenly) that the reported combined revenue was for Gurney's alone, and thus "adjusted" the erroneously calculated Gurney's rooms revenue to make two entirely different numbers match. (Tr. at 209.) (*See also* Tr. at 160-61.) This error was carried forward in all subsequent "normalization" adjustments because HVS simply could not get its fabricated numbers to match reported data. *See* Figures 6-2, 6-3 and 6-7.

Given that Gurney's faced increased expenses from the seasonality of its business (you still have to maintain a beachfront hotel with its restaurant and spa during low-revenue Winter months), management and CBRE projections (which, as discussed above, have been far more accurate than HVS' projections) are for rooms expenses to be 30.3% and 29.3% of rooms revenue, respectively. The effect of being overly aggressive in estimating expense is significant, as, based on HVS' projected base year rooms revenue ($17.1 million), each 1% underestimate of expense will add $171,000 to Gurney's EBITDA. Conservatively, HVS has underestimated rooms expense by 5% (i.e., ***it has overstated EBITDA by $855,000***).[13] As with rooms revenue, CBRE and Gurney's management were far more accurate than HVS in their projections of 2018 expenses. Through August, rooms expenses were already over 27% of revenue. That percentage will increase with the addition of expenses incurred during Winter months, when expenses are a much higher percentage of revenue.[14] (*See* Gurney's Exh. 3.)

Finally, HVS' uncertified "addendum" ascribing a fair market commercial value to the Gurney's name is similarly unreliable. The unrebutted evidence adduced at trial establishes that (a) two of the three licensing fee income streams from which HVS derived its brand value *do not exist* (Tr. at 231-32); (b) the third source of licensing fee income derives from a transaction between affiliates, which is not generally an accepted indication of market value[15]; and (c) even

[13] HVS also rationalized that it could achieve lower administrative and general expenses by using different managers, but ignored that Gurney's had long-term contracts in place. *See* HVS Appraisal at 17 (identifying long term management contracts); at 125 (noting that it made a "downward adjustment" to general and administrative expenses because a "buyer of the subject property would likely anticipate reducing expense in one or both categories"). Thus, where CBRE projected such expenses would be 10% of revenue, HVS estimated it would be only 9%. *See* CBRE Appraisal at 96; HVS Appraisal at 127.

[14] Mr. Baum purports to derive "tremendous support" for his "value conclusion" from the fact that the 37 Panoramic rooms next door to Gurney's generated approximately $4 million in rooms revenue, claiming that the capitalized value of such revenue was approximately $2 million per room. (Tr. at 168-70.) Yet, this testimony was misleading because $4 million was the *gross revenue* generated by the Panoramic rooms. Income capitalization is, of course, based on the net income (i.e., EBITDA). If the profit margin for Panoramic is similar to that of Gurney's (i.e., 15.5%, as projected by HVS [at page 127]), then the per room value of Panoramic is only $310,000. This hardly lends support to HVS' opinion that Gurney's is worth over $1 million per room (HVS Appraisal at 154). CBRE's opinion that Gurney's was worth $770 per room is more reasonable in light of available data.

[15] *The Appraisal of Real Estate* (Appraisal Institute 13th Ed. 2008) at 304, warns that transactions "that are not arm's length market transactions . . . should be identified and rarely, if ever, used" in the sales comparison method of

counting the affiliate licensing fees, Mr. Baum admitted that he had no data from which they can be estimated (*id*. at 234), and his lowest projection of licensing fee income ($625,000) was far more than any reported licensing fees actually received by Gurney's from this source. (*Id*. at 235 and HVS Appraisal at 164, Figure 3.)[16] Given that not one unaffiliated third party has ever paid or offered to pay one cent to use the Gurney's name, no value can be ascribed to it.

CONCLUSION

The evidence adduced at the hearing conclusively demonstrates that the projected income stream from which HVS concluded that Gurney's has a value of $115 million was inflated by at least an $800,000 overestimation of rooms revenue and an $855,000 underestimation of rooms expenses.[17] CBRE's valuation methodology, by contrast, was competently executed and relied on actual reported data and logic to estimate (far more accurately) the revenue Gurney's is expected to generate now that it is no longer burdened by partial cooperative ownership. The 2018 actual performance data that CBRE did not have when it conducted its appraisal confirms that CBRE projections were close to actual performance and its analysis was therefore reasonable and reliable. The Court should conclude that the fair value of Gurney's as a going concern as of the day prior to the merger was $84 million and that the fair value of Respondents' shares is therefore $94.93 per share.

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valuation. Furthermore, when employing the income capitalization approach, the same source states that "[t]o develop an opinion of market value with the income capitalization approach, the appraiser must be certain that all data and forecasts used are market-oriented and reflect the motivation of a typical investor . . . ." *Id*. at 450.

[16] The Court rejected Respondents' attempt to offer lay witness testimony to support their argument that, in addition to the appraised value of Gurney's (and its brand name), they should receive a share of the purported value of net operating losses on Gurney's books and the value of the occupancy rights they claim they lost through the merger (even though those rights were eliminated months earlier). Insofar as there is no record evidence to support these add-ons, and they are not addressed in HVS' expert appraisal report, any post-hearing argument that they should be added to Gurney's appraised value must be rejected. *See* Gurney's Pre-Hearing Memorandum at 9-10.

[17] This $1.65 million overestimate inflates EBITDA by 26.6%, and thus accounts for more than $30 million of HVS' $115 million value estimate.

Dated: New York, New York
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