

At IAS Part 15 of the Supreme Court of the State of New York, in and for the County of Nassau, 100 Courthouse Drive, Mineola, New York on the ___ day of _____, 2019.

P R E S E N T :

HON. VITO M. DESTEFANO
J.S.C.

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

-against-

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

Index No. 606128/2015

**FINDINGS OF FACT
AND
CONCLUSIONS OF LAW**

The issues of this Special Proceeding having been heard by me, one of the Justices of this Court, at IAS Part 15 hereof, held in and for the County of Nassau, in a bench trial which was held on November 14, 2018, November 15, 2018, February 25, 2019, March 5, 2019, April 3, 2019, April 4, 2019, May 15, 2019 and May 16, 2019, and having considered the allegations and proofs of the respective parties, and due deliberation having been had thereon,

NOW, after reading and considering the Post-Trial papers submitted, and hearing the testimony, I do hereby make the following findings of essential facts which I deem established by the evidence and reach the following conclusions of Law.

FINDINGS OF FACT

1. Respondent Kraus USA, Inc. ("Kraus") was formed on February 23, 2007.
2. At the formation of Kraus, the individual Respondents, Russell Levi ("Levi") and Michael Rukhlin ("Rukhlin"), were the sole shareholders/Directors of Kraus.

3. Petitioner, Sergio Magarik (“Magarik”) was not a founding shareholder of Kraus. Rather he was an independent contractor/salesman for Kraus in 2007 and 2008. As of January 1 2009, Magarik became the owner of a 20% share in Kraus, which increased to 24% as of January 1, 2010.
4. In his Verified Petition dated September 21, 2015, Magarik sought Judicial Dissolution of Kraus pursuant to BCL § 1104-a. In addition, the Petition contained five other causes of action (the “Fault Claims”) with approximately 100 separate allegations, all of which were predicated upon claims of fraud, misconduct and corporate malfeasance by Levi and Rukhlin.
5. Magarik could not have entered into an oral shareholders agreement with Levi and Rukhlin at the formation of Kraus as he alleged in his Verified Petition.
6. The disastrous and dire financial condition of Kraus, intentionally caused by Levi and Rukhlin, as is alleged throughout the Verified Petition, was completely contradicted and negated by the trial testimony of both Magarik and his valuation expert, Randall M. Paulikens, of Friedman LLC (“Paulikens”), the latter having testified to having been impressed by Kraus growth over a relatively short period of time, and valuing Magarik’s 24% interest in Kraus to be \$7,011,000 as of the statutory Valuation Date of September 20, 2015.
7. In two prior Decisions and Orders, this Court has determined that certain of Magarik’s unsupported allegations and statements, specifically including his status as a founding shareholder of Kraus, and Kraus’ financial condition as of the Valuation Date, alternatively made in the Verified Petition and/or later submitted Affidavits, were

contradicted by documentary evidence, including his own tax returns, and/or Pauliken's deposition testimony.

8. The Kraus tradename and logo are owned by ICG Licensing; a fact known to Magarik.
9. Daniel Lusby is the CFO of Kraus, was first hired as Controller of Kraus in October, 2013, and elevated to CFO in April, 2014.
10. Prior to becoming CFO, Lusby did not need to know the business aspect of Kraus.
11. Lusby did not have any professional training, or degrees for making projections for any company.
12. Lusby created his first financial model and rolling one (1) year Kraus forecast in mid-February, 2014, and presented it to ownership, including Magarik. He updated his projections monthly, thereafter, based upon sales information provided by the Levi, Rukhlin and Magarik, as that information was available.
13. None of the monthly Kraus forecasts were ever met in calendar year 2014, nor were any of the 2015 monthly forecasts ever met, through the Valuation Date.
14. Lusby prepared the June 8, 2015 (hereinafter alternatively referred to as the "Management Forecasts"), which were included in the loan application package to the then-prospective lender, BHI, and which projected Kraus' revenues, expenses, etc., through the end of calendar year 2016..
15. The parties stipulated that Kraus-prepared financial forecasts dated as of February 18, 2015, April 7, 2015, June 8, 2015, June 10, 2015, June 19, 2015 and June 22, 2015, each of which were provided to BHI as part of the loan application process.
16. The June 10, 2015, June 19, 2015 and June 22, 2015 forecasts contained updates to the (June 8) Management Forecasts.

17. The Management Forecasts included the anticipated income from the sales an entirely new “family” of products, the manufacture and launch to market of which, were expected to be financed with funds from the BHI loan.
18. The closing of the refinance loan with BHI occurred in July, 2015.
19. As of the Valuation date, the launch of the new products had been delayed.
20. As a result of the delayed launch, the projected sales of the new products had not been met as of the Valuation Date.
21. Paulikens noted that the fact that Kraus had a research and development department (“R&D”) was a factor in his conclusion that Kraus was a brand. However, he did not know when the R&D department began, what equipment they had, the number of employees or amount of money allocated to R&D, and had no knowledge as to whether Kraus ever manufactured any of its own products.
22. Kraus did not have a R&D department in 2014 or 2015.
23. No money was used or applied for R&D in 2014, or 2015, other than the purchase of a 3-D printer in early 2015, which no one at Kraus knew how to use, and no products were produced on it as of the Valuation Date.
24. For his Income Approach to valuation, Paulikens blindly adopted the Management rolling forecast for 2016. He did not vet the projections, nor did he visit the Kraus facility, or make any investigation or independent attempt to verify the accuracy of the Management Forecasts, or the knowledge and experience of Lusby, the person who had created them.
25. Without any personal knowledge whatsoever, Paulikens opined that BHI must have relied on the Management Forecasts, which was presented by Kraus to BHI, as part of BHI’s

due diligence, and that the lender's reliance was sufficient to allow Paulikens to rely on them as well.

26. Paulikens testified that the Management Forecasts were only one part of the due diligence documents which Kraus had provided to BHI, and that he did not know what, if any, weight BHI attributed to any one document, or part of the due diligence package over another.
27. The BHI loan was asset based, backed by personal guarantees of Kraus' Shareholders and Kraus' ability to borrow, or drawn down on the line of credit, was subject to limits, which required, among other things, a pre-determined balance of inventory and accounts receivable.
28. Kraus never borrowed more than \$6M from BHI as of the Valuation Date.
29. Kraus had previous loans in the total amount of \$5M, with various lenders, which were paid off at the closing of the refinance with BHI.
30. Paulikens acknowledged that the Management Forecasts included the anticipated income from the sale of the new products, but did not consider any risks associated with Kraus' ability to achieve the anticipated results.
31. Paulikens reviewed the actual financial numbers for Kraus as of December 31, 2015 (post the Valuation Date), which differed substantially from the Management Forecasts, but accepted the Management Forecasts for 2016 without adjustment for the actual 2015 year end revenues, expenses, etc. He did, however, adjust the 2016 portion of the Management Forecasts to the extent that he thought the loan interest figure was too low.
32. Paulikens created his own 4-year projections for 2017 through 2020 for the company, based upon the Management Forecasts, using his own assumptions and presumptions.

33. Paulikens applied a discount to the values achieved in his Income Approach based solely on his experience and opinion, without any analysis.
34. Paulikens admitted to having used the entire 2015 year-end financial numbers in his Market (comparable) Approach.
35. Paulikens' Market Approach to valuation heavily relied on his having determined Kraus to be a brand.
36. Paulikens has no training, education or training in marketing, or in determining when a company becomes a brand. He is not a marketing, nor a branding expert.
37. Paulikens' determined that Kraus was a brand based upon what he heard at the pre-trial depositions and internet searches for customer reviews, which he conducted on Kraus after he was retained in October, 2016.
38. Paulikens never heard of Kraus prior to having been retained in 2016.
39. Paulikens did not know when, i.e., in what year, the customer reviews which he saw on the internet were posted, by whom, or whether they were accurate.
40. Magarik considered Kraus to be a brand as early as 2006, when he helped to write the early advertising materials for Kraus, prior to its formation in early 2007.
41. From late 2006 and for several years thereafter, Magarik was among those chiefly responsible for writing the Kraus marketing and advertising materials, in which he used the word "brand" since the beginning.
42. As of the valuation date, Kraus was only in existence for approximately 8 years, had 50 employees and its net sales were less than \$34M annually. It sells sinks and faucets which are sourced in China.

43. In his Market Approach, Paulikens used guideline public conglomerate companies, and compared Kraus with them, including: Fortune Brands, Lixil, Masco, QVC, Restoration Hardware Holdings, Home Shopping Network, Roy Ceramics, Toto, and Wayfair.
44. Almost all of the comparable companies used by Paulikens were well established conglomerates, public companies with a long history, some, more than 100 years old, which own numerous brands and sell numerous categories of products worldwide, with many thousands of employees, and billions of dollars in annual revenues.
45. Some of the comparable companies chosen by Paulikens were not in the business of selling sinks or faucets, such as QVC and HSN, which sell a multitude of different products worldwide, via a television platform.
46. Paulikens testified that there was no way to know what percentage of any his comparable companies' annual revenues were generated from the sale of sinks and faucets.
47. Wayfair sells products from its website; Kraus does not.
48. None of the companies used by Paulikens is comparable with Kraus.
49. Kraus is unlike Tesla. Kraus is not unique and revolutionary.
50. Paulikens acknowledged that Kraus' lower price points could be a factor in its sales growth.
51. Paulikens acknowledged that the lack of direct compatibility is an inherent flaw in the approach he used.
52. Paulikens applied, without any specific criteria, or analysis/adjustment, a 10% across-the-board discount to his market approach in order to adjust for the lack of direct comparability between Kraus and his guideline companies.

53. The parties litigated the Fault Claims alleged in the Verified Complaint for close to 3 years.
54. In support of Magarik's motion to compel discovery, Paulikens submitted an Affidavit in which he claimed that all of the Kraus documentation and information sought was crucial to his ability to properly value Kraus, and to determine what, if any, adjustments needed to be made to the valuation as a result of the Fault Claims.
55. Paulikens received the equivalent of more than 200,000 pages of Kraus' financial and other documents in response to discovery demands, but did not look for, nor did he find any evidence of any of the fraud, mismanagement, and related allegations which are stated in the Verified Petition.
56. Paulikens valued the future and the Fault Claims were historical and irrelevant to his valuation.
57. Paulikens testified that he believed the Fault Claims to have been "set aside" prior to his having furnished his Report on fair value, which is dated August 7, 2017.
58. Magarik's Fault Claims were withdrawn by Stipulation dated July 26, 2018.
59. The individual Respondents exercised their right of election to buy Magarik's 24% interest pursuant to BCL 1118(c) at fair value.
60. Paulikens relied on Revenue Ruling 56-60, which speaks to "fair market value", a different standard than "fair value".
61. Unlike the Paulikens, Respondents' valuation expert, Paul G. Marquez of BizValue, Ltd. ("Marquez") actually corroborated his income approach with the Direct Market Data Method, a market approach, and applied regression analysis to justify his reliance on the

method and for his overall conclusion. In addition, Marquez surveyed broker rules of thumb to gauge the reasonableness of his conclusion(s).

62. Marquez credibly posited that use of any comparable approach without a comprehensive financial vetting of the companies selected should not be used. Without such an analysis, any basis for multiples selection by an expert would not be valid or reliable, if not properly adjusted for differences in risk size and growth in economic fundamentals.
63. Marquez credibly and correctly testified that the use of the guideline public company method is reliable, if applied correctly by the appraiser.
64. Paulikens did not apply the guideline public company method correctly, in that he did not calculate a median, harmonic mean, nor present a standard deviation or coefficient of variation to his data selection to analyze the data selected.
65. Marquez credibly and correctly testified that Kraus was 98% below its (overly optimistic) operating income target of \$5.457M, having earned a mere \$90,946 for the first nine months of 2015.
66. Marquez credibly and correctly testified that Kraus was limited in accessing its asset-based loan ("ABL"), based upon its actual borrowing base and other operating and financial statement conditions in the loan.
67. Marquez pointed out that as of September 30, 2015, Kraus' book value (or tangible net worth = TNW) was less than \$750,000 wherein Kraus was required to have a TNW of \$1.5 million in order to increase the ABL from \$7.0 million to \$10 million which would allow Kraus to meet any working capital shortfall. The maximum amount that Kraus was able to borrow under the BHI loan terms was barely \$6M, i.e., only \$1M dollars more than the funds which they had available prior to the BHI refinance.

68. Marquez credibly and correctly testified that without additional working capital, the company cannot grow its sales any faster than it had previously, which was at a rate of 25%. Kraus therefore could not have met the 41% growth projected in the 2016 Management Forecast, which would therefore have to be reduced to at least 25%.
69. Marquez credibly and correctly testified that Kraus was running out of cash and at the end of 2015, Kraus only had \$17,471 of cash.
70. Kraus could not borrow more money to meet the working capital shortfall because they had already borrowed the maximum allowed based upon the borrowing base ratios contained in the loan documents.
71. Marquez did not rely on Management Forecasts, having deemed them unreliable.
72. Marquez visited the Kraus facility more than once.
73. Marquez had numerous conversations with Lusby to understand, among other things, who at Kraus created the Management Forecasts, their knowledge, experience and ability to do so.
74. Marquez vetted the Management Forecasts.
75. Marquez, as a result of his vetting, knew that Kraus had never met a single one of their projections for sales or income, i.e., they were historically unreliable.
76. Marquez credibly determined he could not utilize the Company's projections, as they were based on unreasonable assumptions.
77. Marquez utilized a single-period discounted cash flow (i.e., capitalization of cash flow or income) with an optimistic weighting of the Company's prior income results.
78. Marquez presented a more realistic DCF model, but did not rely upon it in his final analysis and conclusion.

79. Marquez vetted the YEP Analysis with Lusby, and used them as a guide to normalize earnings and project future operations in his own DCF.
80. The growth and operating metrics Marquez employed were based on more reasonable assumptions that comport to Kraus' actual operating activity.
81. Marquez ascribes value to Kraus as a Marketeer, predominantly a wholesaler of kitchen faucets and sinks.
82. Marquez credibly and correctly testified that the tacit value in Kraus lies, not in its "brand", but in its business plans with its Chinese manufacturers, marketing efforts, distribution relationships in the U.S., pricing, cooperative advertising, and incentives.
83. Marquez credibly and correctly testified that if Kraus had brand value, it would also have pricing power and excess earnings, which it did not.
84. Marquez projected a normalized cash flow as of the 3rd Quarter of 2015, which comports to the Valuation Date and what was "known or knowable" in terms of the Company's actual earning capacity as of the Valuation Date.
85. Marquez applied a DLOM, not to the 24% interest but to the Company as a whole. This is the proper application of a DLOM in that it does not bias a minority interest holder, but subjects every shareholder to the same treatment.
86. Marquez presented the Court with applicable factors and analysis of his determination of a discount for lack of marketability for Kraus and Magarik's 24% interest.
87. Marquez correctly found that the DLOM would be affected by the time value of money, transaction costs, key-person considerations, potential royalties, and other case specific risks.

88. Marquez also considered a conventional DLOM based on rates of return affected by Kraus' own revenue size, market value, total assets, book value, and its operating margin compared to market data.
89. Marquez applied a middle range of his estimate of the DLOM of 25% to his conclusion for the fair value of the Company before calculating the pro-rata 24% interest of \$1.1 million.
90. Kraus is not a brand.
91. The Court finds the Management Forecasts unreliable and therefore rejects Paulikens' DCF valuation and conclusions.
92. The Court finds that Paulikens' Market Approach is unrealistic, not having used any companies which are actually comparable to Kraus in his analysis, and having failed to make appropriate adjustments for the great disparities between them and Kraus, including, size, sales, income, market, and different industries. The large disparity between his two methods of valuation, which he simply weighted equally, is unreliable.

CONCLUSIONS OF LAW

1. A court's responsibility is to "ensure that an expert's testimony both rests on a reliable foundation and is relevant to the task at hand." *Nease v. Ford Motor Co.*, 848 F.3d 219, 229 (4th Cir. 2017) and with respect to reliability, a court must ensure that the proffered expert opinion is based on scientific, technical, or other specialized knowledge and not on belief or speculation. *id.*

2. Where the company had demonstrated a historical inability to create accurate projections, the defense expert's Discounted Cash Flow Analysis, relying on those projections,

should be rejected as “unreasonable and unreliable”. In *In re Global Technovations, Inc.*, 210 WL 2671706 (Bkrcty. E.D. Mich.),

3. Litigation-driven valuations should be rejected as unreliable. See, *Gray v. Cytokine PharmaSciences, Inc.*, 2002 Del. Ch., LEXIS 48.

4. Company projections made for litigation purposes and litigation driven are not reliable and should be rejected. See, *In re Family Dollar Stores, Inc. Stockholder Lit.*, 2014 WL 7246436, at 22.

5. The expert’s valuation is unreliable when he makes his own projections in preparing his DCF, *Gray, supra.*

6. The expert’s market approach is unreliable where the comparable companies the expert used were much larger than the company he valued, both in terms of revenue and market capitalization. *Gray, supra.*

7. An expert’s projections should be rejected where they are overly speculative and by implication, unreliable. *Schooltz v. Schooltz*, 27 Va. App. 264, 498 S.E.2d 437, 1998, Va. App. LEXIS 255.

8. Management projections performed by inexperienced personnel should be rejected. *In PetSmart, Inc.*, 2017 WL 2303599, at page 86 (Del Ch 2017),

9. When the differences between the companies identified as comparables is so large, the use of the comparable company method is meaningless for valuation purposes. See, *Neal v. Alabama By-Products Corp.*, Del.Ch., C.A. No. 8282, 1990 WL 109243, (Chandler, V.C.) (Aug. 1, 1990), slip op. at 21, aff’d, Del.Supr., 588 A.2d 255 (1991); *Citron v. E.I. DuPont de Nemours & Co.*, Del.Ch., 584 A.2d 490, 510 (1990). **1266.

10. Where the differences between the subject company and the so called comparable companies as to product mix, revenues, profit margins, earnings, growth rates, asset size and geographic markets, all combine to make any comparison with Kraus totally meaningless. See, *In re Radiology Associates, Inc. Litigation*, Court of Chancery of Delaware, New Castle County, November 1, 1991, 611 A.2d 48517 Del. J. Corp. L. 1257. *Merlin Partners LP v. AutoInfo, Inc.*, 2015 WL 2069417 (Del. Ch. Apr. 30, 2015).

11. When “the factual underpinnings of the DCF computation become unreliable ... the propriety of any use of DCF (and the weight DCF conclusions should be given) becomes debatable at best.” Id. at *18, 2014 Bankr.LEXIS 2011 at *57–58. *In re JCC Holding Co., Inc. S'holders Litig.*, 843 A.2d 713, 721 (Del.Ch.2003).

12. A DCF analysis is problematic where management's projections are inaccurate or unreliable. See, e.g., *Adelphia*, 2014 WL 2057791, at *10–11, 2014 Bankr.LEXIS 2011, at *33; See also, *In re DBSD N. Am., Inc.*, 419 B.R. 179, 197 (S.D.N.Y.2009).

13. While accepted by a Court, prospective methodologies, such as discounted cash flow, rest on a certain amount of speculation and opinion. See *In re Delaware Racing Ass'n*, Del.Supr., 213 A.2d 203, 212 (1965); *Cottrell v. Pawcatuck Co.*, Del.Supr., 128 A.2d 225, 231–232 (1956), cert. denied, 355 U.S. 12 (1957). If nothing else, such a fact should put the Court on notice. A discounted cash flow analysis, is only as good as the inputs to the model. *Neal v. Alabama By-Products Corporation*, Del.Ch., C.A. No. 8282, Chandler, V.C., slip op. at 22 (Aug. 1, 1990) (citing S. Pratt, *Valuing A Business: The Analysis and Appraisal of Closely Held Companies* (2d ed. 1989) at p. 84.)

14. An inability to reconcile a comparable companies analysis and a DCF analysis has been determined to be an indicator of unreliability. *Lippe v. Bairnco*, 99 Fed.Appx. 274, 279 (2d

Cir.2004); *To-Am Equip. Co. v. Mitsubishi Caterpillar Forklift Am., Inc.*, 953 F.Supp. 987, 996–997 (N.D.Ill.1997) *aff'd* 152 F.3d 658 (7th Cir.1998) .

15. Where an expert's opinion used that is not “based on sufficient facts or data” and is also not “the product of reliable principles and methods properly applied,” the result should be rejected. *Lippe, supra*; *In re Rezulin Prods. Liab. Litig.*, 369 F.Supp.2d 398, 425 (S.D.N.Y.2005).

16. An expert opinion is unreliable and not based on sufficient facts and data when the expert “made no attempt to reconcile his view [] with a number of real world events”. *Point Prod. A.G. v. Sony Music Entertainment, Inc.*, No. 93 Civ. 4001, 2004 WL 345551, at *10 (S.D.N.Y. Feb.23, 2004).

17. A court should exclude expert valuation testimony if the expert bases his analysis on an inappropriate set of cash flow projections. *Frymire–Brinati v. KPMG Peat Marwick*, 2 F.3d 183, 186–87 (7th Cir.1993).

18. The Fair Market Value standard is interpreted to mean the facts that were “known” or “knowable” as of the valuation date. The Court may consider the company's past performance as well as future events, but only if they are "known or susceptible of proof" as of the valuation date. *Murphy v. U.S. Dredging Corp.*, 74 A.D.3d 815 (2d Dept. 2010), quoting *Matter of Miller Bros. Indus, v. Lazy Riv. Co.*, 272 A.D.2d 166, 168 (1st Dept. 2000) (internal quotation marks omitted).

19. The Court must not speculate about the company's future performance. *Matter of Cohen*, 168 Misc. 2d 91 (Sup. Ct. N.Y. Co. 1995); *aff'd*, 240 A.D.2d 225 (1st Dept. 1997).

20. A discount for the company's lack of marketability (“DLOM”) recognizes that a potential investor would pay less for shares in a close corporation because they could not readily

be liquidated for cash. *Friedman v. Beway Realty Corp.*, 87 N.Y. 2d 161, 165 (1995), *Blake*, 107 A.D.2d at 149(DLOM is appropriate because “the shares of a closely held corporation cannot be readily sold on a public market”).

21. The Court “is not statutorily obligated to award pre-judgment interest, or any interest at all, to Petitioner” and that the Court “has the discretion to establish payment terms. *Adelstein v. Finest Food Distributing Co.*, 2011 N.Y. Misc. LEXIS 5956 (citing, *In the Matter of the Dissolution of Seagroatt Floral Company, Inc.*, 78 N.Y.2d 439, 445 (1991)”.

22. The Court is not required to award the statutory rate of nine percent for prejudgment interest set forth in CPLR § 5004. *Murphy, supra*. Rather, prejudgment interest must be awarded at an “equitable” rate. *See BCL §1118(b)*; *see also Matter of Whalen v. Whalen's Moving & Storage Co.*, 234 A.D.2d 552, 651 N.Y.S.2d 579 (2d Dept.1996)

23. Where prejudgment interest is awarded, it “is not awarded as a penalty or to punish a party, it is a cost imposed for having the use of another party's money over a period of time. *Giaino v. Vitale*, 101 A.D.3d 523, 956 N.Y.S.2d 41 (1st Dept. 2012), *citing, Manufacturer's & Traders Trust Co. v. Reliance Ins. Co.*, 8 N.Y.3d 583, 838 N.Y.S.2d 806, 870 N.E.2d 124 [2007].

CONCLUSION

For the reasons stated above:

- The Court hereby adopts the valuation of Marquez, and finds that the fair value of the Company, before calculating Magarik’s pro-rata 24% interest, to be \$6.05 million;
- That a DLOM of 25% is warranted in this case;
- The Court declines to award prejudgment interest;

- That Magarik is entitled to Judgment in the sum of \$1,089,000.00, at the statutory rate from the date that a copy of the judgment is entered hereon with notice of entry;
- Respondents' request for a 4 year pay-out of the Judgment is hereby granted.

Dated: _____

J.S.C.