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MEMORANDUM

**SUPREME COURT - STATE OF NEW YORK**
**COUNTY OF NASSAU**

**PRESENT:**
**HON. IRA B. WARSHAWSKY,**
**Justice.**

**TRIAL/IAS PART 10**

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

Petitioners,

INDEX NO.: 002640/2006

Shareholders in United States Dredging Corporation,

-against-

UNITED STATES DREDGING CORPORATION, et al.,

Respondents.

This court held a hearing to determine the fair value of United States Dredging Corporation for the purposes of a B.C.L. § 1118 buyout. The court then rendered a decision which required each side to submit a new determination for the income approach method of valuation based on factors determined by the court in its decision dated May 19, 2008. Specifically, the court directed that the experts use a capitalization rate of 5.50%; a present value factor of 0.2441%; a holding period, if and when appropriate or needed for the valuation, of nineteen years; working capital of \$6.45 million; non-working capital of \$9.704 million; account for the PHC tax, if needed, by the other calculations; use a lack of marketability discount of 15%; and a discount rate of 7.5%. After receiving the parties submissions in response to the aforesaid decision the court corresponded with the parties in a letter dated July 2, 2008 (Exhibit A to respondents' second response) requesting clarification of certain specific issues raised by their submissions made in response to the decision of May 19, 2008.

Specifically, the court requested in said response:

> The court would expect the parties to explain the difference in expenses (all reference to the first year of the spread sheet - 2006). A short discussion addressing the need, as seen by respondents, to award a dividend of $169,095 (again 2006 and thereafter) versus the position now taken by petitioners that a PHC tax would never come about for the reasons stated on page 3 of its Supplementary Response; a comparison and explanation of the petitioners' use of respondents' deductions in 2006 and 2007 used in the passive approach, as taken during trial and why they differ from what respondents have chosen to use for those years at this time.

Apparently petitioners' expert believed there were other factors that could or should be factored into the equation – the treatment of the pension plan of March 29, 2006, and the appropriateness of the directors' compensation. Essentially he attempted to reargue them. If the court's decision was not clear, let me clarify it. The appropriateness of the directors' compensation is completely irrelevant to recalculating or calculating "value" as per the income approach. Further, the court ruled that the pension plan, though finally enacted after the valuation date, was to be considered as if it had been enacted prior to the valuation date. However, the court has learned new information about the pension plan from respondents' expert which relates to expenses which will be discussed herein.

It appears that what is described by petitioner's expert as "Case I" in his recalculation dated June 23, 2008, best reflects the court's ruling. The Case I scenario from Mr. Fielstein sets forth the following:

| | |
|---|---|
| Value from discounted cash flow: | $ 8,740,164 |
| Add: Non-working capital: | $ 9,704,000 |
| Less: 15% lack of marketability discount | ($ 2,766,625) |
| Less: January 2007 dividend | ($ 1,000,000) |
| Income approach value: | $14,677,539 |
| Petitioners' combined interest (36.77%): | $ 5,396,931 |

In reaching this conclusion petitioners have determined that there would be no PHC (Personal Holding Company) tax on the corporation.

The respondents' expert from Holtz, Rubinstein provided the following recap:

| | |
|---|---|
| Discounted cash flow valuation: | $ 7,172,100 |

| | |
|---|---|
| Plus non-operating assets: | $ 9,703,700 |
| Less: Discount for lack of marketability at 15% | $ 2,531,400 |
| | $14,344,500 |
| Less: Adjustment for dividend distributed | $ 1,000,000 |
| Value after adjustment: | $13,344,500 |
| Petitioners' share at 36.77%: | $ 4,906,800 |

Petitioners' and respondents' expert also accounted for dividends necessary to avoid the PHC tax. As can be seen from the above, the major dollar difference between the parties is how they calculated the discounted cash flow value.

Basis for difference:

1. Petitioners applied a 10% income rate ($645,000) on the working capital. Respondents used a 6.7% rate of return ($432,150) resulting in a difference on this ground alone of $212,850 in 2006.

The court, in the decision of May 19, 2008, stated that "the 10% yield is contrary to a historic 6% rate of return" of the equity market. The court has been unable to locate in the record a source for that statement, but believes it was drawn from cross-examination of petitioners' expert by respondents' counsel. In a letter of September 11, 2008, the court requested each party to submit all references - testimonial and evidentiary - as to how they reached the percentage rate of return on the "working capital." Each side responded with appropriate references in submissions dated September 26, 2008, including references to the experts' reports and their testimony.

In the four page cover letter which accompanied the experts' submission of July 31, 2008, the petitioner addresses the varied items that were set forth in the court's letter of July 2, 2008. However, the petitioner does not limit itself to the elements of the court's letter in its response. Essentially, the petitioner argues that the court has erred in accepting the 6.7% rate as the proper rate of return on those non-operating assets as part of the discounted future cash flow method. He believes the court may have referred to a particular item in evidence known as USDH-2551 (bates stamp nomenclature) in error. At least 50% of the four-page letter appears to be a motion to renew and or reargue. The court will disregard any part of the transmittal letter/cover letter dated July 31, 2008 that is neither responsive to the court's letter requesting clarification of the prior submissions nor responsive to the respondents response to the court's letter.

The article provided to the court by MWE entitled the "Long Run Stock Returns: Participating in the Real Economy" by Roger Ibbotson and Peng Chen was improperly submitted and was not only not considered, but also not read by the court.

2. A $145,000 difference in expenses with respondents showing $653,050 in total expenses and petitioners' $508,711. The difference in expenses is explained to some degree by the fact that John Murphy's salary was omitted as an expense in 2007 by petitioners and miscellaneous expenses were continued by respondents through December 31, 2008, which were used to "wind down" the passive income scenario used by respondents. (A question arises of how John Murphy should have been able to receive his salary and pension simultaneously, but it is "explained" in the President's Report of "22 June 2006" (Bates stamped USD 4073-4076) four months after the date fixed for valuations.)

In typical fashion, MWE cut off these expenses prematurely while HRR continued them for an unreasonable length of time (in the court's opinion). In 2006, each officer and director received half year directors' fees ($12,500 each), James Murphy and Michael Gallagher each received one-half salary and one-half pension, having retired as of June 30, 2006.

In the first half of 2006, each received $61,282 (salary and directors' fees). In the second half of the year James Murphy and Michael Gallagher received only pension ($50,000 each) and one-half of their directors' fees ($12,500). However, John Murphy, in addition to the above, received $27,500 in what is labeled as one-half year salary in the second half of 2006 (paid to him because he was keeping the financial records of the corporation).

In 2007 HRR has James Murphy and Michael Gallagher receiving $12,500 directors' fees, and then full pension of $100,000 each. John Murphy also receives his full pension of $100,000, directors' fees of $12,500 and now a salary of $27,500 (equal to what was one-half of his 2006 salary as of July 1, 2006).

There was no explanation of why or how John Murphy continued to collect a portion of his former salary and his full pension (one-half year 2006, full year 2007) until the court read the President's Report dated June 22, 2006 (Exhibit H the September 26, 2008 submission and found at trial Exhibit WW). The court will not allow the John Murphy salary deduction as an expense in 2007.

The petitioners' methodology did not consider the payroll taxes on the pension plan as an expense (the pension was not an ERISA qualified plan) and, thus, payroll taxes would have to be paid on the deferred compensation plan. The petitioners were unaware that the pension plan was not an ERISA qualified plan, which added expenses to the corporation.

Should the pension plan have been an ERISA qualified plan? It would have saved the corporation considerable taxes. Respondents argue that the costs of adopting a qualified ERISA plan would offset any gain on the tax side and, in any event, there would have had to have been a deduction of working capital to cover the set up expenses of the plan.

The court rejects that position. Once again, it is the majority shareholders, the respondents, who controlled the pension set up. The minority shareholders, the petitioners, should not, once again, be punished for the actions of the majority. The court makes no modification to petitioners' fair value amount related to the pension plan. The court disallows any expenses related to the pension plan. The court is more than somewhat annoyed that it learns for the first time at this stage of the proceedings that the pension plan which it approved as being an expense of the corporation (though not enacted until after the valuation date), is now a pension plan which essentially abuses the minority shareholders again. It is a pension plan that keeps on taking from the minority shareholders even after the valuation date.

It is interesting to note that the respondents posit that there is nothing in the corporate records that the corporation had implemented or intended to implement an ERISA - qualified plan which could have mitigated the corporation's payroll tax costs. However, there is also no indication in the same "records" that the corporation intended the type of plan they did choose, or what it would cost beyond the $3 million principal over ten years, or any discussion of the financial impact on the corporation.

The court did not disallow the health insurance plan. It is appropriate to modify the petitioners' total by $15,590 as set forth in respondents' Exhibit B, line 4, to Second Supplemental Report.

3. The respondents also determined that a dividend of $169,095 would have to be made to the shareholders in 2006, and similar amounts thereafter, to overcome a PHC tax. But they now agree that it could be done and that there would be no PHC tax with appropriate dividends.

The petitioners also argue it is not required, and the dividends they showed would be paid to shareholders to avoid the PHC tax. The only difference is that petitioner paid greater dividends due to greater income from a presumed 10% gain on working capital. The petitioners argued:

> In addition to being liable for regular income taxes, a corporation that is classified as a personal holding company will be liable for a separate tax of 15% on its 'undistributed personal holding company income'.
>
> The tests for whether a company is a personal holding company are:
>
> 1) Was more than 50 percent of the value of the outstanding stock owned by five or fewer individuals at any time during the last half of the taxable year, and
>
> 2) Is a substantial portion (60 percent or more) of the corporate income (adjusted ordinary gross income) composed of passive types of income such as dividends, interest, rents, royalties, or certain personal service income.
>
> However, in determining undistributed personal holding company income (and adjusted ordinary gross income), income from rents may be excluded if: 1) rents constitute 50% or more of the company's adjusted gross income, and 2) total distributions are equal to or greater than the amount by which non-rental personal holding company income exceeds 10% of 'ordinary gross income'.
>
> In each of the Cases presented above, we have performed an analysis of whether USD would incur a PHC tax liability. We assumed that USD would continue to be a closely held corporation and would therefore continue to meet the ownership test for PHC status. Our conclusion however is that based on projected distributions and the projected mix of rental vs. non-rental income, USD would not, in any of the Cases analyzed, be deemed to be a PHC in any year during the nineteen year forecast period and would therefore not be subject to PHC tax in any instance (see Case I, Exhibit d; Case II, Exhibit d; and Case III, Exhibit d). (Page 3 of Petitioners' Supplementary Response.)

The court finds that no PHC would be imposed on the corporation, and it will not be further considered by the court. Apparently, it would increase the net amount of working capital and, thus, increase the income from working capital on an annual basis.

In determining appropriate deductions for the years 2006 and 2007, petitioners' expert draws his value from the respondents' expert's approach as seen in passively held DFCF for the years 2008 and onward. However, respondents do not use that approach for the years 2006 and 2007 in the supplementary report. Rather, respondents argue and explain:

> In the passive approach utilized by HRR in the former model, $150,000 of

pension expense was deducted for the six months ended December 31, 2006. In the present model, HRR has deducted a pension expense and associated payroll taxes based upon the decision of Justice Warshawsky dated May 19, 2008. The pension expenses and associated taxes have been calculated from July 1, 2006, the date the pension went into effect (and the same date the salaries of officers were reduced or eliminated).

The major impact of these variances is seen in the payroll taxes line and health insurance. In 2006 alone, respondents show $33,000 in payroll taxes and $30,000 in health insurance while petitioners show $3,265 total for these two lines. Petitioners argue that a "normalization" of expenses is required even though they were paid by respondents. The court accepts petitioners' position on the "normalization" of expenses.

There was nothing in this court's decision of May 19, 2008 that somehow caused the respondents, for the first time, to show those pension expenses after the court's decision. Where were those expenses during trial? Did the respondents and their expert first discover them in June 2008?. If the respondents believed that the pension was a deduction, then there was no reason not to have shown the related taxes that applied thereto, not just the face amount.

Both parties, in response to the decision of the court dated May 19, 2008, and then the follow up letter of the court dated July 2, 2008, submitted reports dated June 23, 2008 and July 31, 2008 (petitioners) and June 5, 2008 and July 31, 2008 (respondents). Each party's recap starts with the other side's DFCF value from their June reports and explains how the other side was wrong and how the results of those errors are reflected in the final valuation.

Using respondents' final valuation from its June 23, 2008 submission, the court makes the following ruling and modifications:

| | | |
|---|---|---|
| Respondents' "Fair Value" using the income approach (DFCF) | | $4,906,800[1] |
| **<u>Add Backs</u>:** | | |
| Normalization of expenses (2006-2007) (court acceptance of MWE's adjustment of expenses): | $ 45,744 | |
| Pension expenses (payroll taxes) taken by | | |

1 This reflects the $1 million dividend payment of January 2007; the 15% discount for lack of marketability; petitioners' 36.77% share of $13,344,500.

| | | |
|---|---|---|
| HRR and rejected by the court: | $ 35,467 | |
| Timing related differences (allowed by the court) | $ 10,371 | |
| John Murphy's salary (PV) in 2007 while being paid pension: | $6,580 | |
| **Sub-Total:** | | $ 98,162 |
| **Total:** | | $5,004,962 |

In response to the courts September 11, 2008 letter, which had requested each side reference to the court what evidence supported their specific experts position on what pre-tax interest could be earned on the money held as "working capital", as noted earlier each side quickly responded as of September 26, 2008 with references as requested by the court. The court had specifically requested just evidentiary and testimonial references and no oral argument to support each individual parties position. Despite that request, the respondent's counsel at the end of the letter that accompanied the material he submitted made the following statement:

"The respondents do not contest Mr. Fielstein's conclusions (MWE Appraisal, EX. 4 at page 27, quoted above) that bonds should be estimated to yield approximately 4.76% pretax and equities approximately 10.6%. The sole issue for the court to determine is whether a prudent business would invest in stocks the monies that are intended for the discharge of short-term obligations, of the Company."

It is interesting to note that this argument is being made now and to the court's recollection was never previously made in either the pretrial, posttrial or supplemental memoranda submitted by respondent's counsel. It is however an interesting argument.

To recap, the petitioner chose a 10% pretax rate of return on working capital assuming reinvestment of interest and dividends. They used a 90% investment in equities and a 10% investment in bonds. (John Murphy had testified that Bernstein management had invested the Corporation's money and it was currently earning, at the time of his testimony 9-10%. This investment was apparently made after the February 2006 valuation date.) This percentage rate of return was calculated on working capital of only $2.1 million. The court had agreed with the respondents argument that that amount of working capital would be insufficient as working capital of this real estate investment company.

Thus, in a post-decision world, where the court had greatly enlarged the amount of money to be held as working capital should the same percentage continue, are there sufficient funds to have such a rate of return from a mix of equities and bonds as well as income from the real estate held by the corporation to pay their expenses and still have the ability to have these kind of holdings in the equity and bond market? And, as pointed out by the respondents' counsel, is it a prudent business decision to hold in the equity market money that may be needed to pay short-term obligations? The issue of whether this would be a prudent business decision in light of all the other factors is one that was never argued by either side. Therefore, it was never previously addressed by the court in its decision of May 2008. It should be noted that respondent's expert, in its report, exhibit A in evidence at trial, assumes that $15,800,000 would be held in working capital, invested in a mix of 60% bonds and 40% stock with a target annual return of 6.7%, less brokerage fees and transaction costs. Respondents expert believed that that was the rate of return that the corporation was receiving on the $15 million that was currently being earned on the monies being held by Bernstein, the broker for the Corporation. More specifically, Mr. McAteer, respondents' expert, stated "I think we used the same rate of return in our projections and I think net of fees it was 6.7%." The respondents report is dated May 30, 2007. There is no testimony or evidence that actually reflects that the Bernstein management assets were earning 6.7% net of fees, nor were the Bernstein management reports for the period in question ever introduced into evidence or provided to petitioner's counsel or its expert.

It is also clear to the court that each party's experts and their attorneys never really spent any substantial time on this issue pretrial, during trial, or post-trial, compared to the balance of the testimony and evidence. There were many other important, significant issues upon which they concentrated. Thus, it is understandable why the request of the court on this issue was not met with extensive substantive material, but the court is satisfied that the parties have responded as fully as possible.

It is clear from Mr. Fielstein's testimony that he used the testimony of John Murphy as to what the Bernstein management investments were paying, 9-10%, but also did his own research to confirm that amount. For the purposes of a bond yields, he used a 20 year United States treasury bond as a fixed income security at approximately 4.76%. The expected risk premium for an equity investment-meaning buying a stock-would be 5.85% (based upon a guide which tracks investment earnings authored by Roger G. Ibbotson) . Thus, when one combined the two of those together, it would be a little bit over 10%, 10.61% actually. Thus Mr. Fielstein determined that that corroborated what was being earned in the Bernstein account (Trial transcript November 28, 2007 at page 333).

In reaching his conclusions, Mr. Fielstein determined that there would be reinvestment of interest and dividends. Obviously, if one reinvested interest and dividends, then the money that one would expect to be available to pay expenses would not be present. However, Mr. Fielstein also included in his calculations income produced by certain pieces of real property owned by the corporation.

Mr. McAteer ended up with a 6.7% rate of return on working capital based upon a combination of bonds and equity holdings in a 60-40 ratio. His 6.7% rate of return was net of brokerage fees and transaction costs.

It would appear to the court that if 6.4 5 million was held back as "working capital" as directed by the court's decision of May 2008, it would not be unreasonable to expect a 10% rate of return as compared to a 6.7% rate of return on said funds. Based upon the submissions made to the court in the July 31, 2008 supplemental submission, it would still leave sufficient funds to pay for all expenses of the Corporation as outlined by both experts as well as distributions (dividends) that would be necessary to avoid the holding company tax.

Therefore, the court will modify the above valuation of the income approach by adding to the above number $398,017, resulting in an income approach value of $5,396,399. This amount is then reduced/adjusted for the payment of payroll taxes on the "pension" coincident with when there was no substantial risk of forfeiture ($10,371). The fair value, as determined by income approach is $5,386,028.

The court previously determined in its decision dated May 19, 2008 that the Fair Value using the net asset cost approach was $6,654,267. Based upon the testimony of both Mr. Fielstein and Mr. McAteer they would give greater weight to the valuation reached by the income approach than they would by the net asset cost approach value. Therefore, the court will place a 45% weighting on the Net Asset Cost Approach and a 55% weighting on the Income Approach.

Therefore, the fair value of the petitioners' shares of US Dredging Corporation is 45% of

$6,654,267 equaling $2,994,420, added to 55% of $5,386,028, equaling $2,962,315, for a total of $5,956,735.

It must be remembered that in reaching a determination of "Fair Value" we are not dealing with a mere "bean count." The court must balance many factors. It does not claim to be a CPA or have the ability to modify one cell of an excel spreadsheet, thus, change the results of all other cells. The mathematics done by the court cannot be viewed from a scientific view, but rather its efforts to produce a fair result, considering all factors available to it from statute and case law.

The court has become aware of a recent First Department case, Wechsler v. Wechsler, 866 N.Y.S.2d 120 (1st Dept. 2008), which addressed issues involving fair value and built-in gains taxes. The court has reviewed that decision, finds it not applicable to our facts, and not binding on this court.

Submit Judgment on notice.

Dated: December 9, 2008

J.S.C.