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Zelouf Intl. Corp. v Zelouf
2014 NY Slip Op 51462(U)
Decided on October 6, 2014
Supreme Court, New York County
Kornreich, J.
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Decided on October 6, 2014

Supreme Court, New York County

Zelouf International Corp., Petitioner,

against

Nahal Zelouf, Respondent.

653652/2013

Cooley LLP, for petitioner.

Wolf Haldenstein Adler Freeman & Herz LLP, for respondent.

Shirley Werner Kornreich, J.

Petitioner Zelouf International Corporation (New ZIC) commenced this special proceeding, pursuant to BCL § 623, to fix the value of respondent Nahal Zelouf's (Nahal) 25% interest in an entity formerly known as Zelouf International Corporation (Old ZIC), which was merged into New ZIC as of September 5, 2013. This special proceeding, however, has its genesis in a derivative lawsuit commenced by Nahal in 2009, styled *Zelouf v Zelouf*, Index No. 603746/2009 (the Derivative Action). As set forth below, the instant proceeding is the culmination of a dispute over the Zelouf family textile business that has been ongoing for more than a decade.

Background

To fully understand the context of this action, one must go back to 1984, when the family patriarch, Shafik Zelouf, who came to America from Iran, started a fabric import and wholesale business called Zelouf International Corporation. The company, Old ZIC, was a middleman of sorts between fabric manufacturers and garment manufacturers. It engaged in two types of deals: (1) it purchased fabric (in recent years, abroad, usually somewhere in Asia), shipped it to the company's warehouse in New Jersey, and resold it to American clothing manufacturers; and (2) in recent years, it facilitated transactions between fabric producers and garment manufacturers by buying the fabric from the producer who was located abroad and shipping it directly to the garment manufacturer's factory, also located abroad. Shafik ran this business until he died in 2002.

Shafik had three sons: Joseph, Rony, and Emil. After Shafik died, Joseph, who owned 45% of Old ZIC, took over. The remaining equity was owned by Rony (25%), Emil (25%), and Joseph's son, Danny (5%). Joseph died suddenly and unexpectedly in 2004. Danny inherited [*2]Joseph's equity, giving him ownership of 50% of Old ZIC. Danny, however, had only recently graduated college and had been working for the company in a minor administrative role under the supervision of his father. His 2004 salary was $44,400. Rony, who worked in sales, was appointed a director at the beginning of 2004 and made $101,600 that year.

After Joseph's death, Danny, the majority owner, appointed himself President of Old ZIC and named Rony the Vice President. Emil, who had worked at the company under Shafik and Joseph, continued to work at the company. In the summer of 2004, Emil made a series of books and record requests. On July 7, 2004, Emil asked Rony about his records requests. In response, Rony assaulted Emil. Later that day, Emil underwent a previously scheduled surgical procedure, which rendered him in a coma. Emil remains in a vegetative state. Nahal, Emil's wife, sought to obtain title to Emil's shares after his incapacitation. Danny and Rony objected, requiring the involvement of lawyers. After much cost, Nahal obtained Emil's 25% equity on June 19, 2006.

In 2005, Danny increased his salary to $159,300 and Rony's salary to $128,500. While Rony's salary continued to rise, topping out at $419,442 in 2011, Danny's salary increased far more substantially. Danny made $236,800 in 2006, $426,765 in 2007, $479,600 in 2008, $881,650 in 2009, $1,278,100 in 2010, $1,741,100 in 2011, $1,738,500 in 2012, and $1,746,632 in 2013. Moreover, both men took millions of dollars of interest-free loans from the company, which they only began to repay with interest after they were sued by Nahal in 2009.

In 2006, Danny began paying his mother, Kathrin, a "salary" from the company. Kathrin received $124,800 in 2006, and continued to receive a six figure salary every year until 2013, when her compensation decreased to $86,000. Danny stipulated that he paid his mother a total of $906,000 from the company; he admits that she was paid this money despite performing no work. Danny also admits that the company's financial statements and tax returns treated Kathrin's "salary" as a business expense.

In 2007, Danny and Rony admit they began leasing a fleet of luxury cars that cost the company approximately $100,000 per year. Most of the cars were not used for business purposes but rather for personal use by the men and their families. Additionally, in 2008, Danny formed another company, called Zelouf West, which he solely owns. Zelouf West began selling to four of Old ZIC's customers (the Legacy Customers). Zelouf West does not have its own office, employees, or even its own bank account. It used the offices, employees and bank account of Old ZIC.

Procedural History

On May 7, 2009, Nahal commenced an Article 78 proceeding in this court (Index No. 601425/2009), in which she sought the company's books and records. After receiving some of the company's records, on December 14, 2009, Nahal commenced the Derivative Action, in which she sued Danny and Rony for, *inter alia*, waste and self-dealing. In response, Danny stopped having the company pay for Emil's health insurance on the supposed ground that, since Nahal complained about benefits given to non-employees, and Emil could no longer work for the company, continuing to pay for his health insurance would be inappropriate. Danny, however, continued to pay for his mother's health insurance and continued to pay her "salary" even though she had never worked for the company. Nahal, as a result, incurred a massive financial burden.

In discovery, Nahal sought records from a database, called MOD2, which tracked all of Old ZIC's inventory. Nahal alleged that the MOD2 inventory records would show that Danny and Rony were understating the company's profitability in its financial statements. Nahal maintained that Danny and Rony were pocketing substantial portions of Old ZIC's revenue, much of which was in cash, for themselves. She contended that while the company's total sales volume was accurately recorded in MOD2, the company's financial statements overstated the cost of goods sold (COGS) and understated the value of the inventory, making the company look far less profitable than it really was. Nahal alleged this enabled Danny and Ronny to steal considerable portions of the company's revenue in a way that would be undetectable, off the books, and tax free. Nahal demanded production of the MOD2 records in discovery so she could prove the discrepancies between MOD2 and the financial statements. The court takes judicial notice of the fact that Danny and Rony fought bitterly to prevent disclosure of the MOD2 records. The court eventually ordered full disclosure of the MOD2 records, but only after much litigation and cost.

The Note of Issue in the Derivative Action was filed on February 9, 2012, and summary judgment motions followed. In an order dated January 3, 2013, the court dismissed Nahal's direct claims, but denied summary judgment on her derivative claims, setting the stage for a jury trial. *See* Index No. 603746/2009, Dkt. 160. During the pre-trial process, the parties procured an independent valuation of the company in conjunction with the parties' attempt to mediate and settle the case. The parties retained Kevin Vannucci of McGladrey LLP, who issued a report dated August 6, 2013, in which he computed a valuation of Old ZIC as of December 31, 2012 (the Vannucci Report), which is discussed in detail below. The parties did not settle. A jury trial, therefore, was scheduled to commence on September 9, 2013.

The case did not go to trial because, on August 19, 2013, Danny and Rony notified Nahal that they were going to effectuate a freeze-out merger. A new company (New ZIC) would be formed, which would be owned by Danny and Rony, and Nahal's shares would be bought out pursuant to a tender offer, which Nahal would have the right to challenge in a special proceeding if she believed the fair value of her shares was more than offered. Nahal immediately moved to enjoin the merger. Her motion was denied in an order dated August 30, 2013 (the Merger Order). *See* Index No. 603746/2009, Dkt. 278. As noted in the Merger Order, the parties agreed that the court would try Nahal's derivative claims in the instant special proceeding. Moreover, the court held that if Nahal prevailed on her derivative claims, the court also would award her reasonable attorneys' fees. The parties then filed a stipulation of discontinuance.

New ZIC filed its petition in this special proceeding on October 22, 2013. The petition sets forth that on September 19, 2013, Nahal was offered $1,556,250 for her Old ZIC shares. Pursuant to BCL § 623(g), Nahal was tendered 80% of this amount. After Nahal did not respond to the tender offer, New ZIC filed its petition. On November 8, 2013, Nahal filed her answer and asserted counterclaims to recover the fair value of her shares and her costs and attorneys' fees. Fact and expert discovery ensued. A bench trial was held before me over 11 days between [*3]March 17, 2014 and July 10, 2014.[FN1] Post-trial briefs were filed on August 8, 2014.[FN2] *See* Dkt. 128 & 130.

For the reasons that follow, the court holds that Nahal is entitled to fair value for her shares in an amount based on the Vannucci Report's valuation (without a SEAM adjustment, a discount for lack of marketability (DLOM), an additional control premium, or adjustment based on Old ZIC's revenue in the first half of 2013, but including revenue from the Legacy Customers), plus additional compensation for Danny's improper waste of corporate assets (Kathrin's "salary" and the luxury fleet of cars), plus additional compensation for the money Danny and Rony stole from the company and hid by producing fraudulent financial statements, plus attorneys' fees.

Legal Standard

BCL § 623 provides that a dissenting shareholder in a freeze-out merger is entitled to the "fair value" of her shares. Pursuant to BCL § 623(h)(4):

In fixing the fair value of the shares, the court shall consider the nature of the transaction giving rise to the shareholder's right to receive payment for shares and its effects on the corporation and its shareholders, the concepts and methods then customary in the relevant securities and financial markets for determining fair value of shares of a corporation engaging in a similar transaction under comparable circumstances and all other relevant factors.

The BCL, however, "offers no definition of fair value and no criteria by which a court is to determine price or other terms of the purchase." *Matter of Seagroatt Floral Co., Inc.*, 78 NY2d 439, 445 (1991). Fair value, therefore, is a question of fact "that will depend upon the circumstances of each case." *Id.* Indeed, "there is no single formula for mechanical application." *Id.*

Likewise, it is well settled that "[v]aluation of closely held corporations is not an exact science, and it is the particular facts and circumstances' of each case that will dictate the result." *Giaimo v Vitale*, 101 AD3d 523, 524 (1st Dept 2012), quoting *Friedman v Beway Realty Corp*., 87 NY2d 161, 167 (1995). "The determination of a fact-finder as to the value of a business, if it is within the range of the testimony presented, will not be disturbed on appeal where valuation of the business rested primarily on the credibility of expert witnesses and their valuation techniques." *Matter of Dissolution of N. Star Elec. Contracting-N.Y.C. Corp.*, 174 AD2d 373, 373-74 (1st Dept 1991); *see Wechsler v Wechsler*, 58 AD3d 62, 95 (1st Dept 2008) ("There is no single set methodology for valuing a closely held business" and, thus, deference is given to this court's fair value finding if such finding "has support in the record"). Nonetheless, there are certain mandatory valuation rules that must guide the court's analysis, such as:

(1) The fair value of a dissenter's shares **is to be determined on their worth in a going**

concern, not in liquidation, and fair value is not necessarily tied to market value as reflected in actual stock [*4]trading (2) The three major elements of fair value are net asset value, investment value and market value. The particular facts and circumstances will dictate which element predominates, **and not all three elements must influence the result**. (3) Fair value requires that the dissenting stockholder be paid for his or **her proportionate interest in a going concern**, that is, **the intrinsic value of the shareholder's economic interest in the corporate enterprise**. (4) fair value determinations should take into account the subsequent economic impact on value of the very transaction giving rise to appraisal rights, as supplemental to the three basic value factors (net asset, investment and market values). [and] (5) Determinations of the fair value of a dissenter's shares are governed by the statutory provisions of the Business Corporation Law that require equal treatment of all shares of the same class of stock.

Friedman, 87 NY2d at 167-68 (citations omitted; emphasis added).[FN3]

Simply put, the court must "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.'" *Id.* at 168, quoting *Matter of Pace Photographers, Ltd.*, 71 NY2d 737, 748 (1988). Once "the investment value of the entire enterprise [is] ascertained," the dissenting shareholder should be awarded a pro rata share based on the percentage of stock owned. *Friedman*, 87 NY2d at 168-69. While "a discount for minority status" is not permitted [*see id.* at 169], courts may apply a DLOM when a "risk associated with the illiquidity of the shares" is proven. *Giaimo*, 101 AD3d at 524; *see Murphy v U.S. Dredging Corp.*, 74 AD3d 815, 818 (2d Dept 2010) (collecting cases).[FN4]

Though the Court of Appeals has not decided the question of who bears the burden of proof in a BCL appraisal proceeding, the parties propose following this court's tradition of applying the "no-burden" approach. Under this approach, the court will consider the parties' expert testimony as persuasive evidence of fair value, but, at the end of day, and even if the court finds neither expert to be persuasive, it is the court's burden to make a fair value determination. *See Matter of Cohen*, 168 Misc 2d 91, 95 (Sup Ct, NY County 1995), *aff'd* 240 AD2d 225 (1st Dept 1997).[FN5] For the reasons set forth below, the court adopts most of Vannucci's valuations, [*5]accepts some of the contentions of the parties' other experts, and disregards the experts' opinions where such opinions are based on arguments or methodologies that the court finds not to be compelling or in contravention of New York law.

That being said, Nahal still has the burden of proof on her derivative claims, but the impact of such claims on the value of the company, if proven, will be decided by the court under the no-burden approach.[FN6] Where the court rules in Nahal's favor, Nahal has met her burden of proof, the standard for which is discussed in more depth below.

The Vannucci Report

The parties agree that the Vannucci Report is the starting point for the fair value analysis of Nahal's shares. The court reviewed the Vannucci Report in comprehensive detail, both as a stand-alone analytical document and in conjunction with the reports and testimony of the parties' experts. The court finds the Vannucci Report to be a comprehensive and reliable indicator of the value of Old ZIC.[FN7] Given the lack of substantial disagreement over the Vannucci Report's findings, the [*6]court limits its discussion to a general explanation of its methodology and the five issues disputed by the parties.

Vannucci's Methodology

Vannucci set out to determine the fair value of Old ZIC on a controlling basis. Vannucci also separately calculated the impact a SEAM adjustment, a DLOM, and the Legacy Customers would have on the valuation. Vannucci understood fair value to be "the price that would be received to sell [Old ZIC] in an orderly transaction between market participants." Vannucci valued Old ZIC as a going concern and assumed it would be able to generate earnings into perpetuity. He considered utilizing three generally accepted valuation approaches (the Market-Based Approach, the Income Based-Approach, and the Asset-Based Approach), and provided a detailed explanation for why he "determined that the only meaningful and reliable valuation methodology in this case was the Income Based-Approach." He then explained why and how he applied the capitalization method (as opposed to the discounted cash flow method). Simply put, Vannucci determined a normalized measure of sustainable economic income, and, in doing so, necessarily had to make normalizing adjustments.[FN8] Vannucci calculated Old ZIC's normalized revenue and sustainable EBITDA margin (4.3%), the latter of which, as discussed below, the parties dispute based on the 2013 financials. Vannucci further calculated a long-term growth rate of 3%, representing a nominal real long-term growth rate after accounting for inflation.

Next, Vannucci calculated the fair value of the Legacy Customers — that is, the value of their revenue to Old ZIC, which Old ZIC would have received if Danny had not moved those customers' business to Zelouf West. Vannucci was expressly agnostic on whether, as a matter of law, Old ZIC was legally entitled to such revenue, but computed the value of the Legacy Customers so the court could utilize the calculation if necessary, based upon legal determinations.

While Vannucci touched on myriad aspects of Old ZIC's business and the industry in which it operated, the parties only dispute two portions of Vannucci's valuation (SEAM and DLOM) and three other possible adjustments to his valuations (control premium, the Legacy Customers, and the impact of the 2013 financials).

SEAM

SEAM (an S-corporation Equity Adjustment Multiple) is a premium added to the valuation of an S-corporation to reflect the pass-through tax benefits not applicable to C-corporations. Since the type of analyses performed by Vannucci were based on assumptions applicable to C-corporations, a SEAM adjustment is often added to the valuation to reflect the benefit to the owner of an S-corporation. However, as Vannucci correctly noted, applying a SEAM premium [*7]is only appropriate when valuing a minority equity interest, not where, as here, conducting a valuation of the entire company.[FN9] This type of valuation is in accord with New York law. *See Friedman*, 87 NY2d at 168-69. New York law does not permit an independent valuation of the minority's equity, which would entail a separate valuation methodology and which might warrant a SEAM premium. Vannucci only calculated a hypothetical SEAM at the direction of counsel, but did not believe it should be added. The court agrees. While the parties dispute Vannucci's SEAM calculation (particularly the issue of the applicable individual tax rates), this dispute is irrelevant because a SEAM adjustment should not be made.

DLOM

Vannucci computed a 30% DLOM (Discount for Lack Of Marketability). Vannucci noted: "typically, a [DLOM] is usually only applicable for valuations of minority interests in closely-held companies under the assumption that a controlling owner would be able to force the sale of the company. However, at the direction of counsel, and consistent with the scope of my valuation assignment, I have assumed a hypothetical condition by including the [DLOM] to conclude on what the value of [Old] ZIC is on a controlling, non-marketable basis." While the parties' experts opined on whether 30% would be the proper DLOM, the court does not weigh in on this dispute because the court agrees with Vannucci's view that a DLOM should not be applied. He correctly reasoned that the assumptions behind the DLOM and its calculation, such as hypothetical impediments to sale and the actual likelihood that Old ZIC would be sold, are entirely irrelevant to the determination of the fair value of Nahal's shares, which is based on her pro rata share of the value of the entire company on a controlling basis.

Petitioner, however, argues that New York law requires a DLOM. While many New York cases discuss DLOM, and, particularly, how much DLOM is proper in various circumstances,[FN10] no New York case stands for the proposition that a DLOM *must* be applied to a closely-held company. The idea of a DLOM is that, since the company as a whole can be difficult to sell (e.g., buyers of closely-held companies in niche businesses are not as plentiful as buyers of publicly traded corporations), a frozen-out, minority shareholder should recover less to reflect this fact. While it is surely true that it would have been difficult to sell Old ZIC — though this may have as much to do with Danny's looting of the company as its closely-held status — the rationale for generally applying a DLOM is inapplicable to Old ZIC.

The methodology employed by Vannucci (the Income Based-Approach, which neither party contends was improper) values the company based on its perpetual future earnings. To a holder of Old ZIC equity, this valuation represents the value received if the equity is held, not sold. Indeed, the record establishes that owning Old ZIC (and now New ZIC) equity has enticing perks. [*8]Moreover, given Danny's testimony regarding the soul of the business being personal relationships, it seems unlikely that the company would or could ever actually be sold. Danny is at the helm of a company in a niche industry that affords him benefits that another company would not provide.

While these facts, at first glance, might appear to militate in favor of applying a DLOM, the rationale for a applying a DLOM breaks down when one considers that any liquidity risk associated with Old ZIC is more theoretical than real. No sale of the company has occurred since its 1984 founding. Nor is there any reason to think that Danny will walk away from a company providing him with millions of dollars in income, a similar, low interest loan facility, personal and family perks and control unless he eventually turns it over to other family members, years down the road.

The company, without Nahal and her family, will always remain under the control of the Zelouf family. This makes the company's illiquidity irrelevant, mooting the concern for which a DLOM accounts. If the other Zelouf family members will never pay a price for the company's theoretical illiquidity, then there is nothing "fair" about artificially depressing Nahal's recovery due to a hypothetical sale that will never occur. To impose such a cost on Nahal is tantamount to levying the very sort of minority penalty that New York law prohibits. In this court's view, the fair value of Nahal's shares should be based on the true value of owning the company that Nahal would have enjoyed had she not been mistreated while a shareholder and forced out when she complained. Liquidity risk only manifests into real cost in an actual sale and should not be imposed here where there will never be a sale and, thus, no real cost.[FN11]

The purpose of a DLOM is to account for "**risk** associated with the illiquidity of the shares." *Giaimo*, 101 AD3d at 524 (emphasis added). Risk, of course, is a function of probability times the threatened harm. While the threat of harm here (a lower net purchase price due to illiquidity costs) is undisputed, the probability that such a threat will actually occur is negligible. Ergo, there is no risk that warrants a DLOM.

While petitioner is correct that a DLOM is applied in most instances, petitioner provides no support for the proposition that applying a DLOM is a mandatory part of the formula for valuing Old ZIC. A rule requiring courts to mechanically apply a DLOM to all closely held companies without considering whether, in some instances, the purpose of a DLOM may not apply, is inconsistent with this court's legal mandate. *See Seagroatt*, 78 NY2d at 445 ("there is no single formula for mechanical application"). Rather, as the Court of Appeals has long recognized, "[v]aluing a closely held corporation is not an exact science" because such "legal entities that by their nature contradict the concept of a market' value." *Id.* at 446.

Old ZIC is precisely the sort of company for which there is no traditional "market." Hence, the court must "consider the nature of the transaction" and, in doing so, the court must consider "all other relevant factors." *See* BCL § 623(h)(4). One such factor is that an actual sale of the company is highly unlikely. Applying a DLOM to Old ZIC (now, New ZIC), therefore, does not reflect the fairest value of Nahal's shares, since the most valuable form of such equity is to own it and reap the benefits. Simply put, Danny and Rony do not suffer from Old ZIC's illiquidity, and, thus, neither should Nahal.

Control Premium

Similarly, no control premium should be applied. Nahal's expert, Professor Anthony Saunders, argued that a control premium should apply due to the myriad benefits of and powers associated with controlling a company. Professor Saunders is correct about the benefits of control (and he is also correct about the private equity market, albeit that is irrelevant since an additional marketability adjustment, be it DLOM or otherwise, is inappropriate here). Nonetheless, a control premium is improper because the company is being valued as a whole. Neither Danny's majority nor Nahal's minority stake is being valued. All inquiries regarding the particular benefits or disadvantages of certain percentage equity stakes are wholly irrelevant to this inquiry.[FN12] The level of control that Danny gained over the company after the freeze-out merger, therefore, is irrelevant.

The Legacy Customers

Next, the value of the Legacy Customers should be included. While Danny explained that these customers purchased different types of fabric than those usually sold by Old ZIC ("junior sportswear" instead of "dressy fabrics"), given the countless variations of fabrics that the company dealt in (as set forth in the MOD2 data), Danny has not convinced the court that the company was not in a position to sell junior sportswear to the Legacy Customers. Indeed, while it is not necessarily inappropriate for Danny to have started a separate division for a different line of fabrics, that is not what he did. He created a separate legal entity, wholly owned by him, and diverted four of Old ZIC's long-time customers to that company, while using Old ZIC's resources to operate it. It is to no avail for Danny to explain that he segregated the businesses with the use of, for instance, intercompany loans and separate allocations of costs and revenues. The problem here is not the lack of adherence to corporate formalities, but rather that Danny's formation of Zelouf West was yet another example of the manner in which his operation of the business advantaged him while disadvantaging Nahal, the minority shareholder. That is the hallmark of this case and the point of Nahal's lawsuit.

The 2013 Financial Statements

Finally, the parties argue about whether the company's 2013 financials warrant an adjustment to Vannucci's valuation. No such adjustment should be made. While Nahal is correct that the law requires Old ZIC to be valued as of the merger date, which occurred in late August 2013 and that Vannucci's valuation was only as of December 31, 2012, Nahal has not submitted any evidence that the value of the company materially increased in the intervening eight months. Nahal merely took the company's financial statements for half of 2013 (which Vannucci did not have) and annualized them by assumed that the company would perform equivalently the rest of the year (a questionable assumption for many reasons, such as the seasonal nature of the industry). Nahal concluded that, in 8 months, the company increased in value by $2.1 million, a 23% increase. But, the company's financials do not actually show improvements to the company's fundamentals, nor did Nahal's experts contend that the company's performance improved. They simply claimed to have conducted the mathematical exercise of plugging in the 2013 numbers and applying various weighting schemes. In other words, Nahal presented no evidence of any actual improved performance. By using a 4-year look-back with equal weighting — when Vannucci chose a 3-year look-back period with the most recent year (2012) weighed double — [*9]Nahal computed a greater normalized EBITDA margin of 5.1% (versus 4.3% calculated by Vannucci). This is problematic for many reasons, but two in particular.

First, even assuming that the company's EBITDA was in the 5% range in 2013, this does not suggest that Vannucci's 4.3% calculation was wrong or even underestimated. The 4.3% number is an average profitability metric that Vannucci thought the company would realize into perpetuity. No matter the projected EBITDA, across an infinite number of future years, the company will have above and below average years. Had Nahal provided substantive evidence of a material change to the business in the first eight months of 2013, such as some market condition improving in a way that warranted a reassessment of the company's projected income, such a fact along with better numbers for the first six months might warrant an upward EBITDA revision. A better six months, without more, does not.

Second, it is entirely unclear if the 2013 numbers were really better. Once a double weighting for the most recent year (2012) is used, the computed increase in value (approximately $350,000 on an $8.893 million valuation) is immaterial. For these reasons, the court finds that Vannucci's valuation based on the Old ZIC's financials through December 31, 2012 is a reliable and accurate measure of the company's fair value as of late August 2013.

Nahal's Derivative Claims

The court assumes familiarity with its prior decisions in the Derivative Action, which discuss the full scope of Nahal's derivative claims. Pursuant to the court's *in limine* rulings, the only derivative claims tried were for events occurring between 2004 and 2010. Moreover, as petitioner correctly argues, since Nahal commenced the Derivative Action on December 14, 2009, Nahal's claims, which are "purely monetary in nature," are subject to a three year statute of limitations under CPLR 214(4). *IDT Corp. v Morgan Stanley Dean Witter & Co., 12 NY3d 132*, 139 (2009).[FN13] Thus, recovery for waste that occurred prior to December 14, 2006 is time barred.[FN14] Additionally, Nahal chose not to pursue certain claims at trial, such as improper tuition payments made to (alleged) family members

Nahal's remaining claims fall into two categories: (1) corporate waste, i.e., Danny's and Rony's excessive salaries and no-interest loans, a no-show "salary" paid to Danny's mother, leasing of luxury cars, and the diversion of the Legacy Customers to Zelouf West; and (2) Danny's and Rony's improper taking of company money, which Nahal proves through a comparison of a forensic audit of MOD2 and Old ZIC's financial statements.

*[*10]Corporate Waste*

It is well settled that "the business judgment rule prohibits judicial inquiry into actions of corporate directors taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes." *Levandusky v One Fifth Ave. Apt. Corp.*, 75 NY2d 530, 537-38 (1990), quoting *Auerbach v Bennett*, 47 NY2d 619, 629 (1979). "So long as the corporation's directors have not breached their fiduciary obligation to the corporation, the exercise of [their powers] for the common and general interests of the corporation may not be questioned.'" *Levandusky*, 75 NY2d at 538, quoting *Pollitz v Wabash R.R. Co.*, 207 NY 113 (1912); *see Fletcher v Dakota, Inc.*, 99 AD3d 43, 48 (1st Dept 2012). However, the business judgment rule does not apply when a director engages in "fraud, self-dealing, unconscionability or other misconduct [not] taken in good faith and in furtherance of the legitimate interests of the corporation." *Levine v Greene*, 57 AD3d 627, 628 (2d Dept 2008), quoting *Gillman v Pebble Cove Home Owners Ass'n, Inc.*, 154 AD2d 508 (2d Dept 1989). "[T]hose types of abuses are incompatible with good faith and the exercise of honest judgment." *See Fletcher*, 99 AD3d at 48, quoting *40 W. 67th St. Corp. v Pullman*, 100 NY2d 147, 157 (2003).

"The essence of a waste claim is the diversion of corporate assets for improper or unnecessary purposes.' To disprove a waste claim, a director who had a personal interest in challenged payments has the burden of showing that they were made in good faith and were fair to the corporation." *SantiEsteban v Crowder*, 92 AD3d 544, 546 (1st Dept 2012), quoting *Aronoff v Albanese*, 85 AD2d 3, 5 (2d Dept 1982). To establish a waste claim based on alleged excessive compensation, "[t]he objecting stockholder must demonstrate that no person of ordinary sound business judgment would say that the corporation received fair benefit. If ordinary businessmen might differ on the sufficiency of consideration received by the corporation, the courts will uphold the transaction." *Aronoff*, 85 AD2d at 5-6 (citations omitted). This inquiry turns on whether "there is a great disparity in values between the assets expended and the benefits received." *Id.* at 6. In other words, the shareholder must prove that the challenged compensation bore no relationship to the value received by the company, rendering it unjustifiably excessive.

Nahal has not made this showing with respect to Danny's and Rony's salaries. To be sure, their salaries were substantial and, perhaps, may have been excessive.[FN15] However, Nahal provides no proof that their salaries were disproportionate to the benefit they conferred on Old ZIC. While the court finds Danny severely lacking in his adherence to his ethical obligations to family and [*11]company, the court recognizes that Danny's value to the company is substantial.[FN16] Without Danny, the company would likely suffer greatly, as its customer relationships would be imperiled as they were after Joseph's death.[FN17] Nahal's reliance on industry average salaries is inapposite because such averages do not account for Danny's actual value to the company. Vannucci, who computed those averages in his report, recognized that his normalizing adjustments are not proof that seemingly excessive salaries are legally wasteful.

Similarly, with respect to no-interest loans, while such loans appear untoward and are in line with how Danny otherwise looted the company, in reality, the only marginal compensation received by taking these loans is the interest expenses Danny and Rony would have incurred had they borrowed this money from traditional credit sources. [FN18] While Nahal makes much of the fact that the loan balances, from time to time, reached seemingly egregious amounts like $2 million, the principle was always repaid. Moreover, Nahal does not even allege that the company had liquidity concerns that were caused or exacerbated by these loans.[FN19] Furthermore, the value of the avoided interest expense is immaterial in proportion to Danny's and Rony's overall compensation. Given that their base salary compensation has not been proven to be so excessive as to be wasteful, the marginal compensation they procured by not having to pay interest does not tip the scales of reasonableness.

Kathrin's no-show "salary" and the luxury car leases, however, are another matter. Paying your mother almost $1 million for nothing is a textbook example of corporate waste. While Danny claimed his mother provided him with emotional support, no reasonable businessman would consider such payments to be justified in the absence of any real value to the company. Similarly, while there is nothing necessarily wrong with a company leasing cars for its employees, when the cars are used by non-employees, or are driven by employees for personal use, and are of a brand of [*12]luxury well beyond what any reasonable company would pay for, the leases are wasteful.

Finally, as discussed earlier, Danny's justifications for diverting the Legacy Customers to Zelouf West are uncompelling. Although the impact of that lost business was computed by Vannucci, and thus does not require a further addition to Nahal's recovery, [FN20] the court finds it appropriate to mention the Legacy Customers in the context of Nahal's derivative claims since the propriety of diverting the Legacy Customers is a question of law for the court, not the parties' experts.

"The doctrine of corporate opportunity' provides that corporate fiduciaries and employees cannot, without consent, divert and exploit for their own benefit any opportunity that should be deemed an asset of the corporation." *Alexander & Alexander of NY, Inc. v Fritzen*, 147 AD2d 241, 246 (1st Dept 1989). There is no single test for determining the existence of a corporate opportunity, but the "tangible expectancy" and "line-of-business" tests are commonly employed. *See Lee v Manchester Real Estate & Const., LLC*, 118 AD3d 627 (1st Dept 2014). Nahal's brief, however, does not set forth these tests or any other applicable legal standard. Petitioner's brief briefly mentions them, but lacks substantive analysis. Based on the evidence produced at trial, the court finds that the Legacy Customers' business was substantially similar to Old ZIC's business, and hence loss of that business was a lost corporate opportunity. The court reaches this conclusion despite those customers buying "junior sportswear", as the court does not find Danny's testimony about Old ZIC's incapability of servicing them to be credible. Moreover, while utilizing a separate company to sell junior sportswear is not inherently illegal, doing so conferred no benefit onto Old ZIC since Danny, and not any of Old ZIC's other shareholders, owns Zelouf West. Even if Old ZIC never before sold junior sportswear, getting into that market by selling to four of its current customers is a corporate opportunity that Danny cannot take for himself before at least offering it to the company. This is particularly true here where Danny used the company's offices, employees and bank accounts to run Zelouf West. The Legacy Customers, therefore, are included in the court's valuation of Old ZIC in the amount computed by Vannucci.

MOD2 Forensic Accounting

Nahal's expert, Elloit A. Lesser, performed what is perhaps the most significant work in the 6 years since Nahal first sued Danny. Lesser, a forensic accountant employed by Berdon LLP, analyzed the MOD2 records and concluded that, for the period between 2004 and 2010, Old ZIC's financial statements understated the value of the company's inventory by $4.9 million, overstated COGS by $717,000, and failed to account for over $14 million in gross profits.[FN21] For the reasons [*13]discussed herein, the court agrees with Lesser's conclusions. As a result, Nahal is entitled to 25% of the value of these omissions. Had such amounts been properly recorded on Old ZIC's financial statements, Vannucci would have incorporated them into his valuation, which then would have been significantly higher.

According to Danny, MOD2 "runs the company." When Danny began working at Old ZIC, he made the astute observation that the company could greatly benefit from an electronic inventory tracking system given the substantial volumes bought and sold by the company. Indeed, without a robust tracking system, it would be nearly impossible to get a grasp of what was stored in the company's warehouse. While the parties agree that the cost data in MOD2 is unreliable, and hence was rightly not used in this proceeding, since MOD2 was implemented in 2002, it is undisputed that MOD2's inventory records are accurate.[FN22]

MOD2 contains a comprehensive inventory breakdown, including quantity, color, style, and yardage data. Lesser conducted an inventory roll forward to value the inventory recorded in MOD2 between 2004 and 2010. Lesser started by looking at the inventory on hand at the end of each year, and then accounted for inventory bought and sold during that year. This allowed Lesser to compute the total volume of inventory on hand and the amounts sold between 2004 and 2010. Then, to assess value, COGS, revenue, and profit, Lesser compared the results with those reported on the company financial statements, which were unaudited and prepared by Old ZIC's long-time accountant, Joel Helman.[FN23]

Since Lesser did not have actual inventory sales revenue or purchase cost data because such data was not reliably recorded in MOD2, Lesser relied on data from the Risk Management Association (RMA) to determine benchmark profitability margins for similar companies. Lesser used RMS data for NAICS code 424310 (the same code Vannucci used to make his normalizing adjustments).[FN24] Lesser used the most conservative of that industry's benchmark profit margins, 25%, and computed a total difference of $14 million between that benchmark rate and the actual gross profit margins reported by Old ZIC.

In other words, Lesser computed the profit a typical firm in the industry would have earned had that firm sold the quantity of inventory sold by Old ZIC between 2004 and 2010. While many firms actually achieve much higher margins (in the 30% range), Lesser's 25% profit margin [*14]assumption represents what a poorly performing, yet profitable firm would have generated.[FN25] To be sure, while it is not a given that a firm makes a profit at all, it was reasonable for Lesser to assume that Old ZIC could not make less than a 25% profit margin and also stay in business for as long as it did. As Lesser explained, firms with profit margins that are consistently well below the low end of industry norms do not stay in business for long, let alone for over a decade (which included the biggest recession since the Great Depression). Indeed, Danny testified that many of the firms that competed with Old ZIC when Danny started in the early 2000's went out of business. It is implausible that Old ZIC could have stayed in business without making at least an average profit margin of 25% between 2004 and 2010.[FN26]

Lesser also noted that it was highly suspicious that in the years immediately after Nahal filed her lawsuits, the company started reporting higher gross profit margins, even though such time period was during the Great Recession. Indeed, not only did Old ZIC report higher profit margins after Nahal sued Danny, but Danny's compensation doubled as well. As noted earlier, one explanation is that, for some reason, the company suddenly became unexpectedly more profitable, and Danny decided to reward himself accordingly. However, there is no support for this theory in the record, nor does any credible evidence (which, of course, does not include Old ZIC's unaudited financial statements) lend credence to this narrative. In fact, the company's financial records since Nahal's lawsuit was filed, including the MOD2 cost data, may well be accurate. But this is not necessarily proof of improvement. Rather, in the absence of any actual explanation for the company's sudden profitability surge in the middle of a recession, the only reasonable conclusion the court can draw is that, as a result of Nahal's lawsuit, Danny decided the threat of judicial scrutiny warranted making accurate financial disclosures for the first time.[FN27] If that is what occurred, then the company did not become more profitable, nor did Danny's actual salary really double. Rather, the reported profit margins were simply the amounts the company was always making, and Danny's reported salary reflects the total value of the compensation he always procured, in one way or another, from the company. Only, this time, it was on the books, and not from secret transfers of money from inventory transactions not reported on the company's balance sheet.

Finally, the court notes that Lesser's methodology is not perfect.[FN28] For instance, if the company's real profit margin was in the 20-22% range, much of Lesser's presumed underreporting of profit would disappear. However, given that Lesser used an extremely conservative comparable profit margin, the implausible and unexplained sudden appearance of profitability along with Danny's attendant supposed salary increase, and, most importantly, Danny's history of committing egregious acts of corporate waste, the court makes a finding of fact that Danny and Rony stole approximately $14 million of profits between 2004 and 2010. The statute of limitations, however, precludes recovery for amounts misappropriated before 2007. Nahal, thus, is limited to recovering 25% of the amounts stolen between 2007 and 2010.

It also should be noted that the incredible amount misappropriated — $14 million — is not implausible. After all, Danny admittedly gave almost $1 million to his mother. The $14 million taken over 7 years represents an additional $2 million per year for Danny and Rony to split. For instance, in 2009, if Danny was willing to pay himself more than $1.2 million, take millions in interest-free loans, and also loot another $125,000 for his mother, it does not strain credulity to believe than Danny was willing to take another $1.5 million per year for himself and give the rest to Rony or other family members. While these are not trivial amounts of money, given the sums Danny made and the other amounts he took, there is nothing implausible about the notion that he plundered $14 million from the company over a 7-year period.

Attorneys' Fees

In the Merger Order, it was made clear that the allowance of the merger was expressly conditioned upon [*15]Nahal being able to pursue her derivative claims and recover her reasonable attorney's fees. As mentioned earlier, while there is scant New York precedent for how to handle quasi-derivative claims, the court never had to reach the issue of whether such claims are permitted because, at oral argument before the merger, "the parties stipulated that the alleged diminution in value of [Nahal's] shares caused by defendants' alleged corporate waste and self-dealing can be factored into the court's appraisal." Merger Order at 3. This understanding was repeatedly confirmed by the parties in this proceeding. While petitioner maintained that Nahal should not recover any attorneys' fees because she was not capable of proving that the fair value of her shares materially exceeds the tender offer or be able to prevail on her derivative claims, these contentions are no longer viable in light of the instant decision.

Therefore, the calculation of Nahal's reasonable attorneys' fees expended in both the Derivative Action and in the instant special proceeding is referred to a Special Referee to hear and report. Such amount will be added to Nahal's recovery. Once the hearing and motion practice, if any, regarding the Referee's report has concluded, a final judgment will be entered.[FN29] billed her substantial sums of money, and, at trial, when too many attorneys' attended, most of whom did not participate in the proceedings. As to trial, Nahal may only recover trial fees for the lead counsel and for the two associates who meaningfully assisted.

Third, for the reasons set forth in the Merger Order, Nahal may not recover attorneys' fee on the direct clams she asserted in the Derivative Action (which were dismissed on summary judgment).

Fourth, Nahal may not recover fees paid to Professor Saunders, whose testimony on a control premium was clearly irrelevant for the reasons discussed earlier.

On all other issues, the Referee shall exercise his or her discretion as to what amounts Nahal should recover. The parties are free to challenge the Referee's findings, but are reminded that the court typically confirms the reports of this court's referees so long as they are reasonable and supported by the evidence in the record. *See Namer v 152-54-56 W. 15th St. Realty Corp.*, 108 AD2d 705 (1st Dept 1985).

Damages

As noted above, the parties will submit proposed judgments computing Nahal's damages. They must be computed based on the following rulings: (1) the fair value of Old ZIC, accounting for everything except the derivative claims and attorneys' fees, is $8,893,000, 25% of which equals Nahal's share — $2,223,250 minus the amount previously tendered pursuant to BCL § 623(g); (2) Nahal is entitled to 25% of the amounts (a) Kathrin was paid by Old ZIC between 2007 and 2010 ($473,600, 25% of which is $118,400) and (b) Old ZIC paid to lease cars between 2007 and 2010 ($401,000, 25% of which is $100,250); (3) Danny stole $14 million from Old ZIC over seven years, but since 3 of the years preceded 2007, the court will only permit Nahal to recover 25% on $8 million (assuming Danny stole $2 million per year for four years, 2007 to 2010), which is $2 million; and (4) pre-judgment interest of 9% shall be computed from (a) October 22, 2013 (the date this action was commenced) on the difference between $2,223,250 and the amount Nahal was tendered and (b) from January 1, 2009 on the derivative damages, a reasonable intermediate date (the midpoint in the 2007-2010 period). *See Arany v Arany*, 282 AD2d 389, 390 (1st Dept 2001), *accord* CPLR 5001(b) (when damages are incurred at various times, interest may be computed "upon all of the damages from a single reasonable intermediate date"). Accordingly, it is

ORDERED that the calculation of Nahal's reasonable costs and attorneys' fees is referred to a Special Referee to hear and report in accordance with this decision; and it is further

ORDERED that a copy of this order with notice of entry shall be served on the Clerk of the Reference Part (Room 119) to arrange a date for the reference to a Special Referee and the Clerk shall notify all parties of the date of the hearing before the Special Referee; and it is further

ORDERED that within 10 days of the entry of the Referee's report, the parties shall contact the court to set a briefing schedule on a motion to confirm or modify the report;

and it is further

ORDERED that the parties will be instructed on the procedure for submitting proposed judgments in the decision on the Referee's report.

Dated: October 6, 2014ENTER:

J.S.C.

Footnotes

Footnote 1: The trial was held on March 17, March 18, March 19, March 20, March 21, April 8, April 11, June 10, June 11, July 9, and July 10. The transcripts for each day can be found at Dkt. 131-141.

Footnote 2: On August 28, 2014, the parties also filed briefs on attorneys' fees. *See* Dkt. 142-155. While the court provides guidance below on the categories of fees that Nahal may recover, the calculation of such amounts is referred to a Special Referee to hear and report.

Footnote 3: While much of the fair value case law pertains to valuation under BCL § 1118, "there is no difference in analysis between stock fair value determinations under [BCL] § 623, and fair value determinations under [BCL] § 1118." *Friedman*, 87 NY2d at 168.

Footnote 4: Nahal erroneously relies on *Cavalier Oil Corp. v Harnett*, 564 A2d 1137, 1144 (Del 1989) for the proposition that a DLOM should never be applied. The excerpt quoted by Nahal [*see* Dkt. 130 at 10] concerns a discount for minority status, which both New York and Delaware law prohibit. A DLOM is something different, and is explained below. Nonetheless, in this case, the court finds that a DLOM should not be applied.

Footnote 5: Justice Crane looked to the burden rules in various jurisdictions and ultimately adopted the burden applicable in the Delaware Court of Chancery, whose governing statute is analogous to BCL § 623 and provides that the court " shall appraise' the fair value of the dissenting shareholders' shares." *Cohen*, 168 Misc 2d at 94, quoting *Cavalier Oil Corp. v Harnett*, 1988 WL 15816, at *20 (Del Ch 1998) ("the Court [must] independently determine that valuation component, even where the parties themselves have tried and failed"), *aff'd* 564 A2d 1137 (Del 1989). It should be noted that, while recent Delaware opinions frame the burden as a double, rather than a no-burden approach ["both parties bear the burden of proving their respective valuations by a preponderance of the evidence"], since "the court may not adopt an either-or' approach to valuation and must use its own independent judgment to determine the fair value of the shares," it appears that Delaware effectively continues to employ a no-burden approach. *See In re Orchard Enters., Inc.*, 2012 WL 2923305, at *5 (Del Ch 2012) (Strine, C.).

Footnote 6: While this case is governed by New York law, the court notes that under Delaware law, a post-merger "quasi-derivative" claim can be maintained, where, as here, "the merger itself is the subject of a claim of fraud, being perpetrated merely to deprive shareholders of their standing to bring or maintain a derivative action." *Ark. Teacher Ret. Sys. v Countrywide Fin. Corp.*, 75 A3d 888, 894 (Del 2013), accord *Lewis v Anderson*, 477 A2d 1040, 1049 (Del 1984). As this court noted in the Merger Order, New York also has a general rule prohibiting post-merger derivative claims [*see Alpert v 28 Williams St. Corp.*, 63 NY2d 557 (1984)], but permits the injunction of a merger under fraudulent circumstances akin to those set forth in *Lewis*. However, New York courts have not developed a system for dealing with quasi-derivative claims. The only similar case on point was *In re Carolina Gardens, Inc.*, 1995 WL 17961777 (Sup Ct, NY County 1995) (Cahn, J.). This court, nonetheless, does not have to rule on the viability of quasi-derivative claims because the parties agreed to have Nahal's derivative claims evaluated in this appraisal proceeding. The viability of quasi-derivative claims when the parties do not agree to allow them, however, remains an unsettled issue in New York.

Footnote 7: Of course, as with any corporate valuation, which inherently involves discretionary judgment calls and reliance on limited information, one can always nitpick at certain conclusions or point to an example of an imperfect analytical method. Aside from the few issues disputed by the parties, Vannucci did an outstanding job and should be commended for his work, especially given the context of the litigation. His report is neutral, thoughtful, precise, and paints a clear picture of the company that is not colored by the parties' rhetoric. While Vannucci did not conduct a forensic accounting audit to determine if Old ZIC's financials were accurate — and, as explained herein, they most certainly were not — his analysis is a trustworthy approximation of Old ZIC's worth without accounting for the value Danny and Rony misappropriated. While Nahal is being awarded additional compensation on her derivative claims, the core of Nahal's award is a corporate valuation that is beyond reproach.

Footnote 8: Vannucci was clear that normalizing adjustments, such as to Danny's salary, were for valuation purposes only, not for the evaluation of a waste claim, the merits of which he did not weigh in on. For instance, a normalizing adjustment to Danny's salary indicates the impact his salary would have on the purchase price of the company, but not whether, as a matter of law (under the standard set forth below), Danny's salary was so excessive that it was legally wasteful.

Footnote 9: One reason is that a controlling shareholder has the ability to change the corporate structure to correspond to the shareholders' (or his own) optimal personal tax circumstances. Hence, a buyer of the entire corporation is often indifferent to the "C" or "S" status of the company since such status can simply be changed after the sale (of course, the corporation must qualify for S-corporation status, and if it does not, a SEAM adjustment would certainly be inappropriate). Ergo, a rational purchaser of 100% of a company would not pay a premium based on a company's status as an S-corporation.

Footnote 10:*See, e.g., Giaimo*, 101 AD3d at 524 (discussing a DLOM for real estate holding companies); *Murphy*, 74 AD3d at 818 (collecting cases regarding a DLOM for goodwill).

Footnote 11: While theoretical illiquidity might increase the cost of debt, this concern was not raised nor was evidence presented that illiquidity affects the company's borrowing costs.

Footnote 12: It should be noted that it would be inequitable to allow for a control premium while the law otherwise prohibits a discount for minority status.

Footnote 13: Though Nahal simply assumes damages are recoverable since 2004, she