

## Diminution in Value Indemnification: Is it Worth the Fight?

By Laurence M. Smith

Among the most contentious issues in the sale of securities issued by a privately held company is the scope of indemnification to which an investor is entitled for a breach of representations and warranties by the issuer. A subset of that issue is the proper measure of an investor's loss upon the occurrence of an indemnifiable event. Sophisticated investors maintain that the appropriate metric is the amount by which the value of their investment has diminished. Issuers who appreciate the ramifications of this position recoil at it, and the battle among lawyers ensues. This article will examine the meaning and basis of a diminution in value indemnification, how it seeks to maximize the recovery available to the investor, and whether the commercial benefit of such an indemnification outweighs the costs associated with demanding it as a condition to making the investment.

### What is a diminution in value indemnification?

Stated simply, a diminution in value indemnification is an indemnification that measures an investor's loss based upon the amount by which the value of its investment decreases as a result of the indemnifiable event. It is the standard measure of loss in certain types of securities litigation.<sup>1</sup> Diminution in value is readily ascertainable when the issuer is a public company: the markets determine in an objective fashion the value of the issuer's securities at any point in time, so a comparison of a stock's price before and after the occurrence of the indemnifiable event yields the desired information. However, with privately held companies whose stock is not traded or quoted on a daily basis, a more complex algorithm is needed to determine value and, in turn, diminution in value.

The reason that an investor often insists that the stock purchase agreement identify the diminution in value of an investment as a type of loss for which an indemnification claim may be asserted can be traced to the law of damages. Generally, damages, including lost profits, must be ascertainable with a reasonable degree of certainty; damages that are speculative in nature typically are not recoverable.<sup>2</sup> Furthermore, in determining the proper measure of damages, courts consider whether a particular type of damages was within the contemplation of the parties.<sup>3</sup> Was it foreseeable that a party would be held accountable for the damages asserted? To the extent an indemnification provision expressly states that an aggrieved investor may recover for any diminution in the value of its investment, that contractual clause strengthens a party's claim for damages of that nature.

### A numerical example

As with many facets of a private equity transaction, understanding the impact of a diminution in value indemnification is facilitated by a numerical example. Assume that an issuer is a manufacturing concern with a pre-cash enterprise valuation of \$25 million, based upon trailing 12 months EBITDA of \$5 million and a multiplier of five. An investor purchases \$12.5 million of the issuer's Class A preferred stock, representing a 33-1/3% equity interest on an as-converted, fully-diluted basis. The purchase and sale of the Class A preferred stock is effectuated pursuant to a stock purchase agreement containing customary terms, including representations and warranties regarding the accuracy of the issuer's financial statements and the collectability of the receivables reflected on the issuer's balance sheet. The net proceeds of the offering are used to retire a portion of the issuer's senior debt and to purchase another production line in anticipation of an expansion in business over the next 12 to 24 months.

Shortly after the transaction closes, a major customer of the issuer files for bankruptcy. Upon investigation, the investor learns that, prior to the closing of the equity financing for the Class A preferred stock, the issuer was aware that its customer was in financial distress but neglected to disclose this fact in the stock purchase agreement or to increase its reserve for bad debts.

Consequently, the related representations and warranties in the stock purchase agreement were inaccurate at the time they were made. During the next fiscal year, the entire receivable owed by the bankrupt customer, in the amount of \$600,000, proves to be uncollectible and must be written off, with a corresponding reduction in EBITDA.

Has the investor sustained an indemnifiable loss and, if so, in what amount? Clearly, the investor suffered a loss. As a one-third owner of the issuer, the investor may assert a claim in the amount of \$200,000, or one-third of the total receivable that had to be written off. If, however, the purchase and sale agreement stipulated that diminution in value was the agreed-upon measure of loss, the investor may argue that its loss is \$1,000,000. That amount is derived from multiplying \$200,000—the portion of the decrease in EBITDA attributable to the investor's one-third stake—by the five times multiplier used to value the company at the time the investor purchased the Class A preferred stock.<sup>4</sup> Should the investor assert a claim for its loss?

The decision to assert a claim against and, perhaps, sue a company of which the would-be plaintiff is part owner is not lightly taken and should be informed by the totality of the circumstances. One consideration is that an investor holding a one-third equity interest in the company most probably has board representation; commencing litigation or threatening to do so will create a conflict of interest that may preclude continued service on the board by the investor's representatives.<sup>5</sup> Also relevant is that costs incurred by the issuer in defending a lawsuit, resolving a dispute and satisfying any settlement or judgment will, in effect, be borne in part by the investor<sup>6</sup>, inasmuch as it is a one-third owner of the company. Repercussions of a suit by or a judgment in favor of a major shareholder may include triggering a default under the issuer's credit facilities, precluding future equity financings or chilling any coordinated effort to sell the company.

Assuming these myriad considerations militate in favor of asserting a claim for indemnification, the investor can shift its focus to those factors that are germane to any decision to litigate: the likelihood of success, the amount of damages that can be established with the requisite degree of certainty, and the probability that any judgment will be collected. In the fact pattern described above, establishing that the issuer breached its representations and warranties and is answerable in some amount is a near certainty. What is the extent of the investor's damages? With no market for the issuer's securities, quantifying damages will become a battle of the experts that will likely unfold over many years.<sup>7</sup> During that period, the experts' theories of valuation and measurement of the indemnifiable loss may be supplanted by actual events in the company's life cycle. For example, growth in the company's business may materialize ahead of projections, with EBITDA increasing the very next year to \$7.0 million—notwithstanding the write off of the \$600,000 receivable—and that same year the issuer may be sold for \$50 million, representing approximately a seven-times multiple of EBITDA. A return on investment in excess of 30% will likely abrogate the investor's claim for damages. In contrast, the issuer may languish and, four years after the issuance of the Class A preferred stock, be sold for \$35 million, with the investor recovering most, but not all, of its initial investment. In this scenario, can any loss suffered by the investor be attributed to a misrepresentation made more than four years prior to the sale of the company? Moreover, if litigation between the investor and the company is pending at the time of the proposed sale—assuming, of course, the litigation does not derail the transaction—a purchaser of the company's stock will require dismissal of the lawsuit as a condition to closing. Under these circumstances, any settlement will likely be for a fraction of the claim asserted by the investor.

Another potential fate of the issuer is that the bad receivable causes it to default under the financial covenants contained in its senior credit agreement, which the issuer is unable to cure or convince the senior lender to waive. Due to tight credit markets and the issuer's mediocre operating results, the issuer is unable to refinance its indebtedness. As a result, the senior lender institutes suit, forcing the issuer to file for bankruptcy. In that event, the investor's claim for indemnification is reduced to an unsecured, unliquidated claim having little or no value.

## Cost-Benefit Analysis

This article is not intended, and should not be construed, as legal advice in connection with negotiating an indemnification under a stock purchase agreement or deciding whether to pursue an indemnifiable claim based upon the diminution in value of an investment. Rather, the purpose of this article is to underscore the substantial impediments to an investor realizing a significant recovery against a private company in which it has invested, based upon a claim for indemnification under a stock purchase agreement. Counterpoised to this tenuous benefit is the very real danger that an investor's insistence on a diminution in value indemnification may derail an equity financing that is critical to a company's survival. Principals of an issuer may be able to accept the dilution that results from the issuance of preferred stock; however, the notion that a \$1 loss to the company could translate into a damages claim for \$5 by the investor may prove an insurmountable hurdle.

## Case Study

We represented a privately held company in its effort to raise between \$25 million and \$50 million in equity in the fourth quarter of 2008. The company projected that it would violate financial covenants in its credit agreement as of the end of 2008 and, accordingly, sought to de-lever in anticipation of its next submission of a compliance certificate. The company and its investor had agreed upon all material terms in the equity financing documents with one exception: the indemnification provisions of the stock purchase agreement. The investor insisted upon a diminution in value indemnification and, for the reasons discussed above, the company resisted. As the investor or a sister fund had owned equity in the issuer for almost two years and enjoyed board representation during that time period, the company viewed the investor's demand as draconian and refused to capitulate. Likewise, the investor stood its ground and the transaction failed.

The financial difficulties that the company had feared materialized in hyperbolic fashion. Typically counter-cyclical, the company's business for the first time in its history contracted with the economy. The company violated all of its key financial covenants and, in the ensuing discussions with its lenders, could not adequately explain the downturn in business or reliably project when the problems would abate.

At the time that the company breached its financial covenants, the interest rates under its credit facilities, which had closed in the second quarter of 2007, were substantially below market. The lenders therefore availed themselves of the opportunity to reprice the senior and mezzanine loans by 400 and 600 basis points, respectively, this in addition to assessing waiver fees totaling millions of dollars. The toll on the company and its equity holders was devastating.

In retrospect, had the company consummated its equity financing in the late fourth quarter of 2008 or in January 2009, it probably could have averted the financial covenant defaults and the resultant repricing of its credit facilities and associated costs. Ironically, the battle between the company and its investor over a diminution in value indemnification—the benefit of which is subject to debate—visited upon them very real, measurable losses in the form of higher interest rates and restructuring fees. In this instance, the modicum of additional protection that would have been afforded by a diminution in value indemnification did not justify derailing the equity financing.

## Conclusion

Equity investors in privately held companies demand indemnification for, among other things, the issuer's breach of representations and warranties contained in the stock purchase agreement. Moreover, investors seek to define their loss by the diminution in value of their investment, which will likely be based upon a formula similar to the formula used to value the issuer for purposes of the investment. While not inequitable, such an algorithm may support an indemnification claim by the investor that far exceeds any underlying loss suffered by the company itself. The specter of

such a claim makes a diminution in value indemnification a hotly contested issue between investor and issuer. If an issuer is intransigent on this point, before abandoning an otherwise worthwhile investment opportunity, an investor should be mindful of the difficulty of proving diminution in value losses with the requisite certainty--where the issuer is a private company--and the obstacles to collecting on an indemnification claim. Those considerations may lead to the decision by the investor to forego the added protection provided by a diminution in value indemnification.



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<sup>1</sup> See, e.g., *In re Salomon Smith Barney Mut. Fund Fees Litigation*, 441 F. Supp. 2d 579, 589-90 (S.D.N.Y. 2006) ("The 'loss suffered' of course refers to diminution in value of the mutual fund share..."). Indeed, diminution in value might be the only type of loss recoverable, particularly in federal securities fraud cases. See *Chem. Waste Mgmt., Inc. v. Sims*, 939 F.Supp. 599, 601 (N.D. Ill. 1996) (citing *Pommer v. Medtest Corp.*, 961 F.2d 620, 628 (7th Cir. 1992)) ("In suits for securities fraud, the plaintiff may only recover the difference between the price of the stock and its actual value if the truth were known."). See also *Astor Chauffeured Limousine Co. v. Runnfeldt Inv. Corp.*, 910 F.2d 1540, 1552 (7th Cir. 1990) (denying federal securities litigation plaintiff the recovery of lost profits because plaintiff "must take the bitter with the sweet. [Plaintiff] cast this as a securities transaction, and it gets the securities measure of damages.").

<sup>2</sup> See *Ashland Mgmt. Inc. v. Janien*, 82 N.Y.2d 395, 403, 624 N.E.2d 1007, 1010 (1993) (citing, *inter alia*, REST. 2D CONTRACTS §352); *Bykowsky v. The N.Y. Urban Prof'ls Athletic League, Inc.*, 899 N.Y.S.2d 226, 226-27, 72 A.D.3d 590 (N.Y. App. Div. 2010) (upholding jury's award of zero damages in part because "the League's several theories as to its lost profits were speculative.").

<sup>3</sup> See *Ashland*, 82 N.Y.2d at 403, 624 N.E.2d at 1010 (citing, *inter alia*, REST. 2D CONTRACTS § 351); *Honeywell Int'l Inc. v. Air Prod. & Chems., Inc.*, 872 A.2d 944, 953 (Del. 2005) ("The requirement that damages be within the reasonable contemplation of the parties is one of foreseeability. Under that rule, the breaching party is legally responsible for the risks it foresaw or reasonably should have foreseen at the time the contract was made. The plaintiff need not show, however, that the breaching party foresaw either the specific breach that actually occurred or the specific manner in which the loss came about.").

<sup>4</sup> This article is intended not as an exhaustive analysis of the elements that may comprise a damages claim but rather to highlight the magnitude of indemnification claims based upon a diminution in value of an investment.

<sup>5</sup> See *Berry v. Saline Mem. Hosp.*, 322 Ark. 182, 187, 907 S.W.2d 736, 739 (1995) (Lawyer who owed hospital fiduciary duty as a result of serving on hospital's board of directors "should not take any action that conflicts with that duty, such as filing a suit against the hospital.").

<sup>6</sup> See *Diabetes Ctr. Of Am., Inc. v. Healthpia Am., Inc.*, 2008 WL 656508 \*4 (S.D. Tex. 2008) (recognizing that the expense of the subject litigation might have caused the alleged decrease in the value of the issuer's stock).

<sup>7</sup> See *In re Am. Bank Note Holographics, Inc.*, 127 F. Supp. 2d 418, 427 (S.D.N.Y. 2001) ("Indeed, the damage assessments of Plaintiffs' and Defendants' experts who would be called at trial were sure to vary substantially, thus precipitating a 'battle of the experts.' In such a battle, Plaintiff's Counsel recognizes the possibility that a jury could be swayed by experts for Defendants, who could minimize or eliminate the amount of Plaintiffs' losses.").