



2013

GROWTH EQUITY INDEMNITY STUDY

GOODWIN  

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PROCTER

# TABLE OF CONTENTS

## Introduction

Purpose & Criteria .....	1
Methodology Notes .....	2
Key Takeaways .....	3
Deal Sample Overview .....	4

## Deal Points

Indemnity Structure .....	5
Party Responsible for Cash Indemnity .....	5
Receipt of Proceeds .....	6
Correlations: Receipt of Proceeds to Responsibility for Indemnification.....	7
Correlations: Responsibility for Indemnification to Receipt of Proceeds.....	8
Indemnity Payment Gross-ups .....	9
Survival / Time to Assert Claims .....	10
Baskets.....	12
Eligible Claim Thresholds .....	15
Caps .....	16
Escrows / Holdbacks.....	19
International Takeaways	
Eligible Claim Thresholds.....	20
Caps.....	20
Escrows / Holdbacks.....	20

# PURPOSE & CRITERIA

## Purpose

We prepared this Study to help advance the discussion of what is “market” for certain deal terms in growth equity investment transactions. While there are numerous publicly available studies of market terms in buyouts and strategic M&A transactions, we believe this is the first study reporting on the terms of minority growth equity deals.

This Study focuses on indemnification terms because, in our experience, it is in this area that growth equity deals differ the most from venture capital transactions, on the one hand, and buyouts and other M&A deals, on the other hand.

This Study was intended, in part, to test two principal hypotheses we have developed based on our deal experience:

- Monetary indemnification limits expressed as a percentage of the deal value in minority growth equity deals (where the “purchase price” is substantially less than the value of the whole company) do not correlate with similar limits in M&A transactions.
- There is a strong correlation between who receives the proceeds in the deal (target company, shareholders or both) and who is responsible for the indemnity.

Like other surveys of transaction terms, this Study was not intended to dictate the result of any particular negotiation. Rather, it was designed to guide the debate to a range of reasonable outcomes and avoid outlier claims of what is “market” that are not supported by actual transaction experience.

## Criteria

Our goal in establishing our deal data set was to identify transactions that most practitioners would agree fit into the category of “growth equity” investments, notwithstanding that there is no generally accepted definition in the marketplace.

The key criteria we used to define our Study sample were:

- Minority investments
- Profitable targets having positive cash-flow on a trailing 12-month basis at the time of investment
- Targets having equity values in excess of \$15 million

A key factor in establishing our criteria was a desire to exclude smaller, early-stage transactions likely to be more properly characterized as “venture capital” deals, the vast majority of which do not have express indemnification provisions.

*We did not limit our Study only to transactions with express indemnification. The presence of deals otherwise meeting our criteria that lack indemnification provisions is an important aspect of the growth equity market.*

Control transactions were excluded because they typically differ from minority deals in that the size of the investor stake tends to push the indemnity terms closer to those found in buyouts or strategic acquisition transactions.

# METHODOLOGY NOTES

## Process

The data in this Study were derived from the definitive investment agreements for transactions closed by our firm and meeting the eligibility criteria for this Study. The agreements were analyzed by attorneys at our firm and the review of each agreement was quality checked by a second attorney reviewer. A committee of lawyers resolved all discrepancies in the data and completed a final quality control review.

## Deal Sample

The 66 deals in this Study all involved lawyers at our firm representing clients of our firm and necessarily reflect the negotiating perspectives and biases of these lawyers and clients. However, because we represented the investor in some deals and the target company in others, and because in the aggregate the deals in this Study involved dozens of different investors and dozens of opposing law firms, we believe the resulting data are representative of a significant portion of the growth equity market.

## Equity versus Enterprise Value

Most acquisition indemnity studies use enterprise value (i.e., equity value plus indebtedness and cash) as the relevant company value metric for purposes of calculating indemnity caps and baskets as a percentage of company value. However, given the nature of a minority growth equity deal, it is often difficult to accurately determine from the investment documents what the enterprise value of the target company was at the time of investment. Accordingly, when calculating caps and baskets as a percentage of company value in this Study we instead used equity value, which we consider a reasonable proxy to compare against percentages of enterprise value reported for acquisition transactions.

## ABA Study Comparisons

We compared several of our deal points to the corresponding data in the 2011 Private Target Mergers & Acquisitions Deal Points Study published by the American Bar Association (the “ABA Study”). We endeavored in each case (except as specifically noted herein) to match our methodology to that of the ABA Study. Note that we compared our data only to the data reported for 2010 deals in the ABA Study and not to any prior years.

## Data Presentation

All monetary data are reported in U.S. dollars. Investments involving foreign currencies were converted into U.S. dollars based on the prevailing exchange rate on the relevant closing date. The percentages in some of the charts do not add to 100% due to rounding.

## KEY TAKEAWAYS

- ◆ This Study validated our initial hypothesis that indemnity caps as a percentage of investment amount would be significantly higher on average than indemnity caps as a percentage of company value in the acquisition context.
  - For example, **69%** of the deals in our Study that included an indemnification cap had caps greater than 15% of the investment amount, with **36%** of deals with caps having caps equal to the full investment amount.
  - By contrast, only **27%** of deals in the ABA Study had caps in excess of 15% of the purchase price, with only **9%** having a cap equal to the purchase price.

*In our experience, these data result from the fact that most growth equity investors view acquisition indemnity percentages as inapposite when applied to the investment amount in a growth equity deal because they do not relate the risk of loss to the size of the company.*

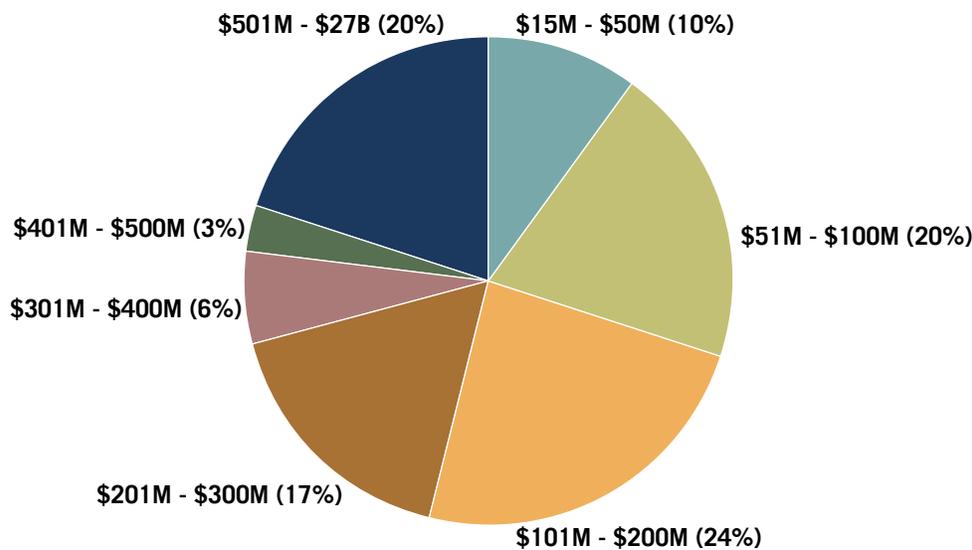
- ◆ We analyzed the correlation between receipt of proceeds and responsibility for payment of indemnification claims and found the strong correlation we anticipated:
  - In deals in which all of the proceeds were received by shareholders, **86%** of the time the shareholders were responsible for the indemnity, either exclusively (**57%**) or together with the company (**29%**).
  - In deals in which all of the proceeds were retained by the company for corporate uses, the company was exclusively responsible for payment of indemnification claims **71%** of the time.
  - In deals in which portions of the proceeds were received by shareholders and retained by the company for corporate uses, the company and shareholders shared responsibility for payment of indemnification claims **57%** of the time.
- ◆ A meaningful percentage of deals (**17%**) included an ownership adjustment in favor of the investor as an indemnification remedy, either instead of cash or as an alternative remedy available at the election of the company or the investor.
- ◆ In deals in which the company provided a cash indemnity, **23%** expressly limited the investor's indemnity recovery to the investor's pro rata share of the applicable loss by the company. In approximately **63%** of those deals, the investor negotiated for a gross-up of the indemnity payment to account for the fact that a portion of each dollar paid by the target to the investor is in effect funded by the investor by virtue of its ownership interest.
- ◆ **35%** of deals in our Study did not place a limit on the survival period of representations and warranties and **41%** did not include any indemnification cap.
- ◆ We studied a number of international deals and found them to be very similar to U.S. deals on most data points. We noted a few respects, however, in which the international deals tended to differ. See "International Takeaways" (Page 20).

# DEAL SAMPLE OVERVIEW

This Study analyzed investment agreements for transactions completed from 2008 through the first half of 2012. The final Study sample consisted of 66 investment agreements, 73% of which involved U.S. targets and 27% of which involved non-U.S. targets.

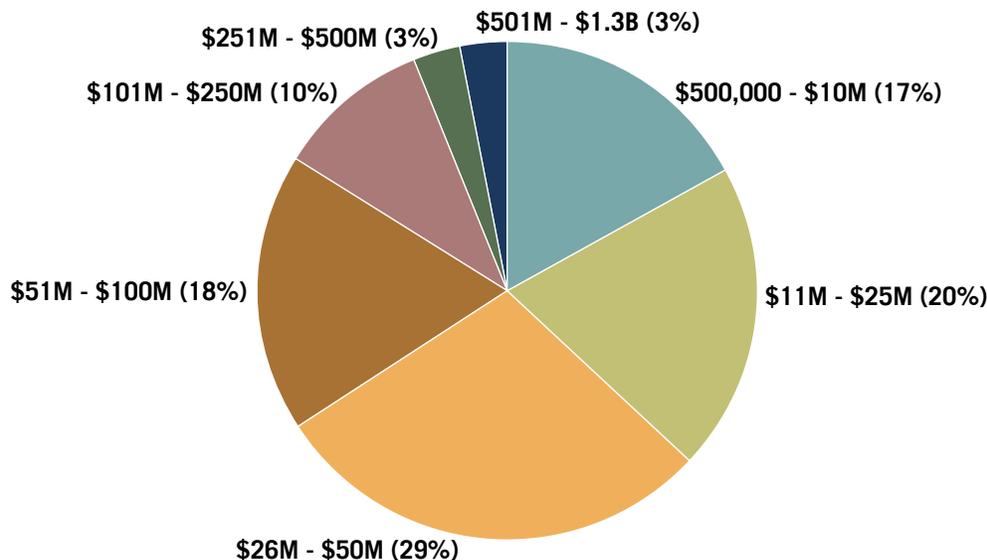
## EQUITY VALUE OF TARGET

Mean	Median	Minimum	Maximum
\$1.75 billion	\$181 million	\$15.9 million	\$27.6 billion



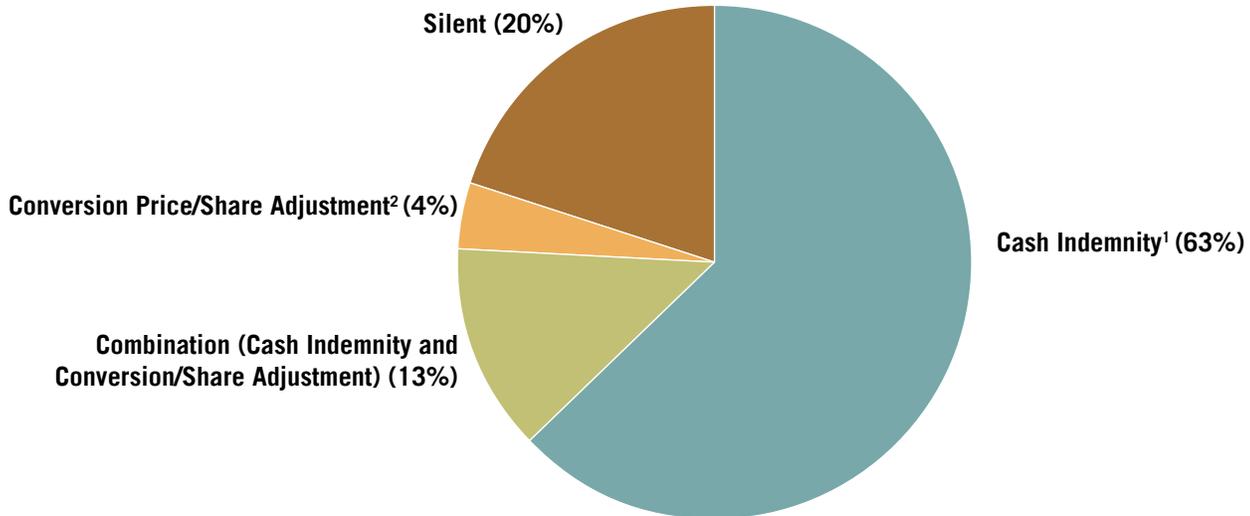
## INVESTMENT AMOUNT

Mean	Median	Minimum	Maximum
\$86.4 million	\$36.0 million	\$0.6 million	\$1.3 billion



# INDEMNITY STRUCTURE

As compared to venture capital investments and acquisition transactions, the absence of uniformity in growth equity indemnity structures makes these deals unique.

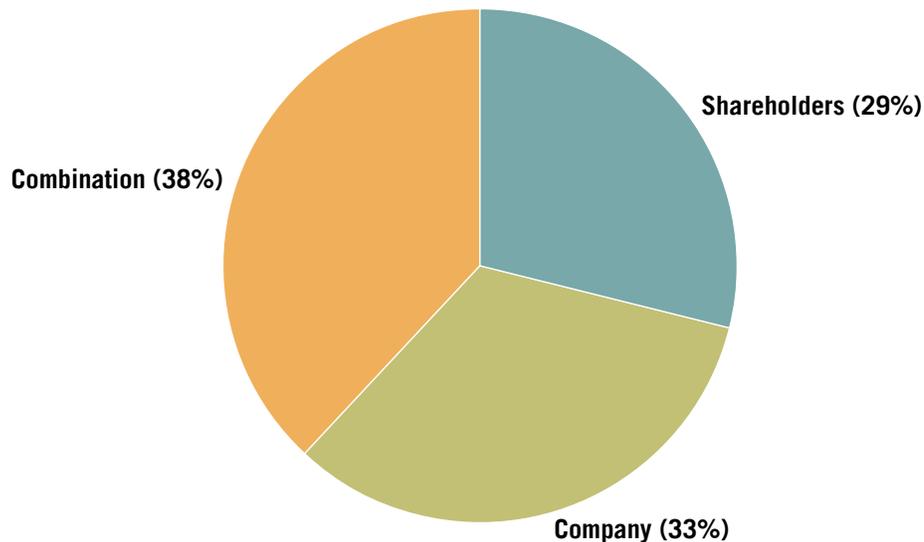


<sup>1</sup> Indemnity claims are payable in cash.

<sup>2</sup> Indemnity claims are satisfied by increasing the investor's ownership percentage to compensate the investor for the impact of the claim on the value of the company.

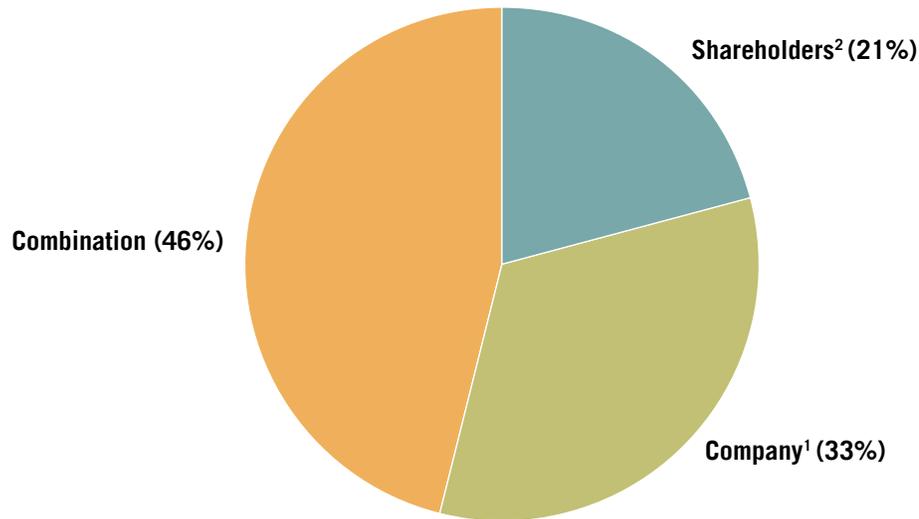
# PARTY RESPONSIBLE FOR CASH INDEMNITY

Subset: Deals Including a Cash Indemnity



## RECEIPT OF PROCEEDS

A principal factor that drives indemnification terms in growth equity deals is who receives the proceeds.

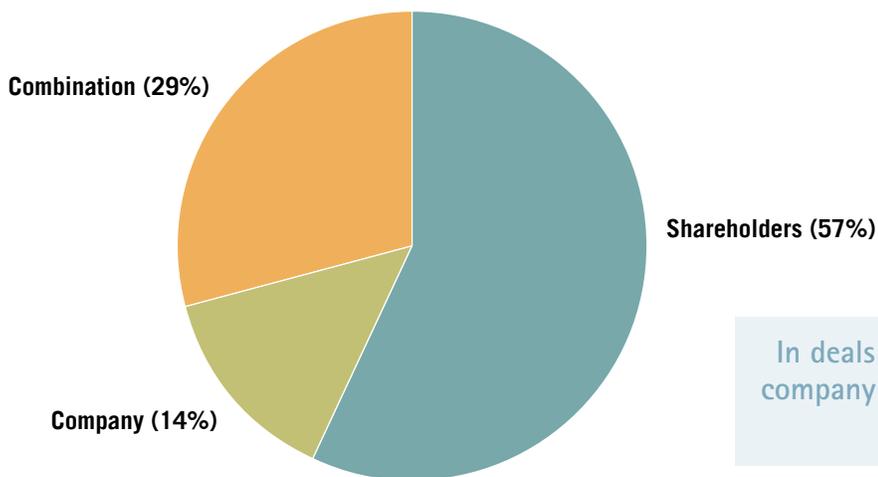


<sup>1</sup> Transactions in which a portion of the proceeds is received by the company and retained for working capital or other corporate uses.

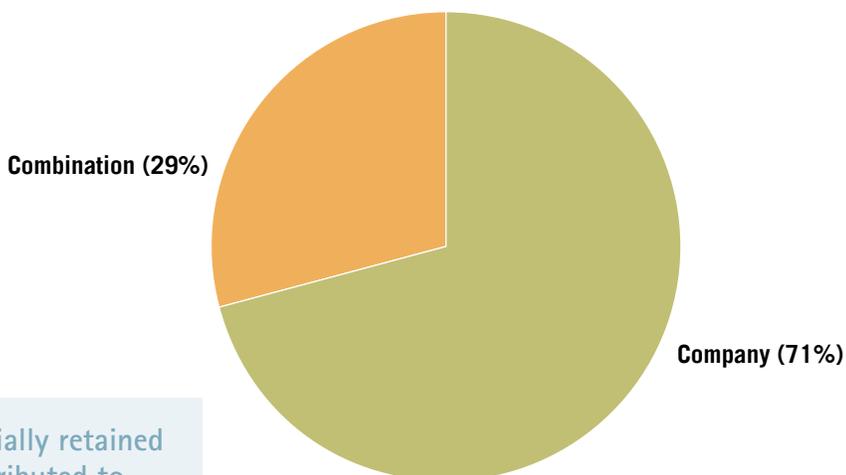
<sup>2</sup> Transactions in which one or more shareholders received a portion of the proceeds, whether through a direct, secondary sale of shares to the investor, a redemption of their shares by the company or receipt of a dividend or distribution.

# CORRELATIONS: RECEIPT OF PROCEEDS TO RESPONSIBILITY FOR INDEMNIFICATION

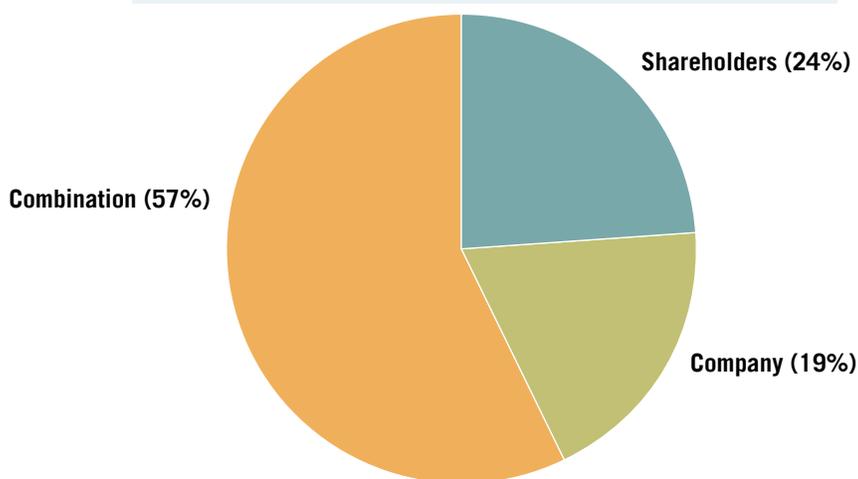
In deals in which all proceeds were received by the shareholders, who provided a cash indemnity?



In deals in which all proceeds were retained by the company for working capital or other corporate uses, who provided a cash indemnity?

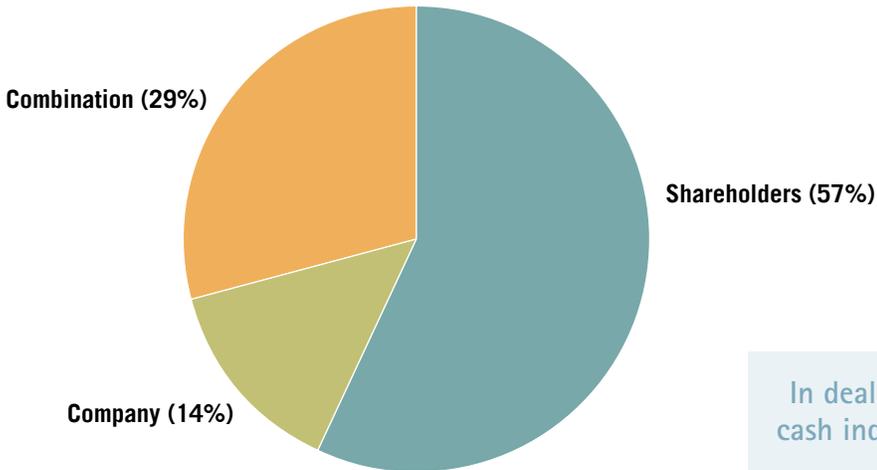


In deals in which proceeds were partially retained by the company and partially distributed to shareholders, who provided a cash indemnity?

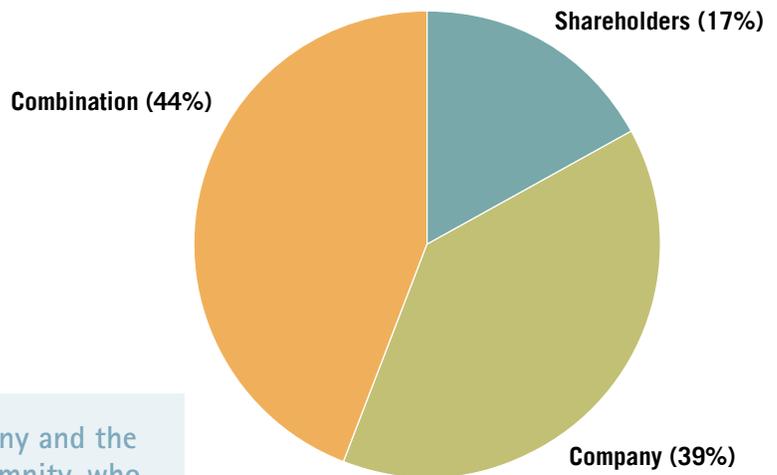


# CORRELATIONS: RESPONSIBILITY FOR INDEMNIFICATION TO RECEIPT OF PROCEEDS

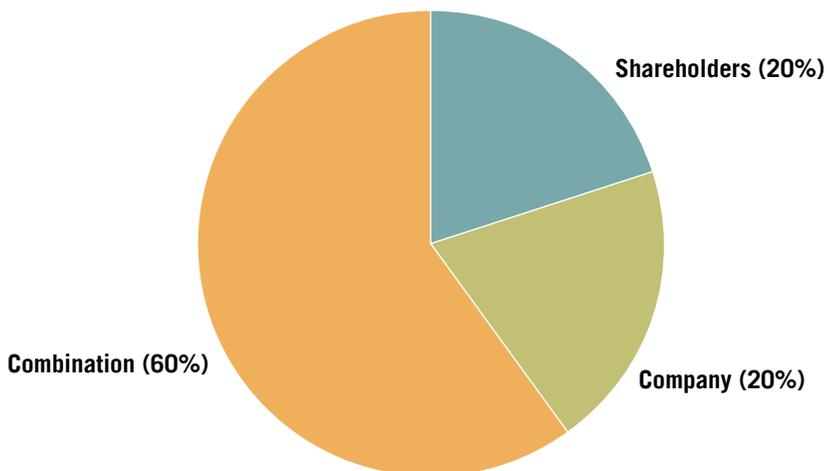
In deals in which the shareholders provided a cash indemnity, who received the proceeds?



In deals in which the company provided a cash indemnity, who received the proceeds?



In deals in which both the company and the shareholders provided a cash indemnity, who received the proceeds?



# INDEMNITY PAYMENT GROSS-UPS

## Sample Provision

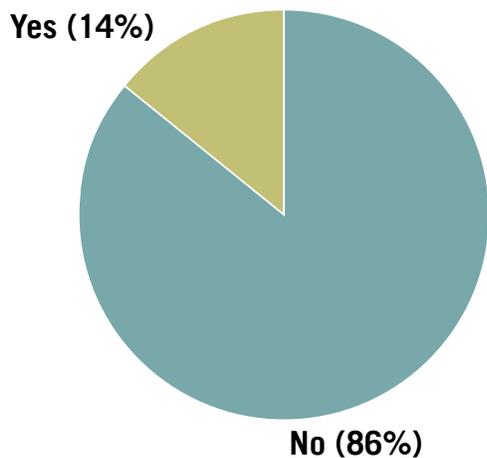
“In the event that indemnification is claimed by any Investor Indemnified Party under Section 6.2(a)(i) due to any breach or alleged breach of any representation or warranty made by the Company and the Stockholders, and the Losses claimed by such Investor Indemnified Party relate to or arise out of liabilities, losses, assessments, judgments, Taxes, fines, penalties or other damages paid or suffered by the Company in direct, out-of-pocket expenditures in connection with such breach or alleged breach (any such out-of-pocket expenditures, “Company Losses”), the amount of indemnifiable Losses that may be sought by the Investor Indemnified Parties relating thereto shall be limited to, and shall not exceed an amount equal to the quotient of (1) the amount of such Company Losses multiplied by 30%<sup>1</sup> divided by (2) 70%.<sup>2</sup>”

<sup>1</sup>Equal to the investor’s pro rata ownership of the Company.

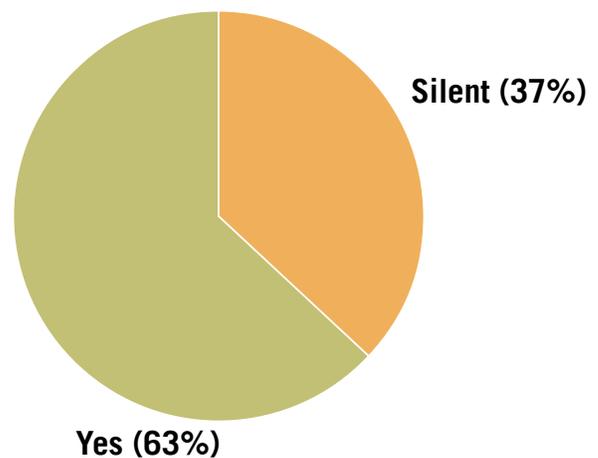
<sup>2</sup>Equal to one minus the investor’s pro rata ownership of the Company.

## Subset: Deals Including a Cash Indemnity Paid by the Company

If the company provides a cash indemnity, is the investor’s recovery expressly limited to its pro rata share?



In deals where the investor’s recovery is expressly limited to its pro rata share, is there a gross-up?



# SURVIVAL / TIME TO ASSERT CLAIMS

## Sample Provisions

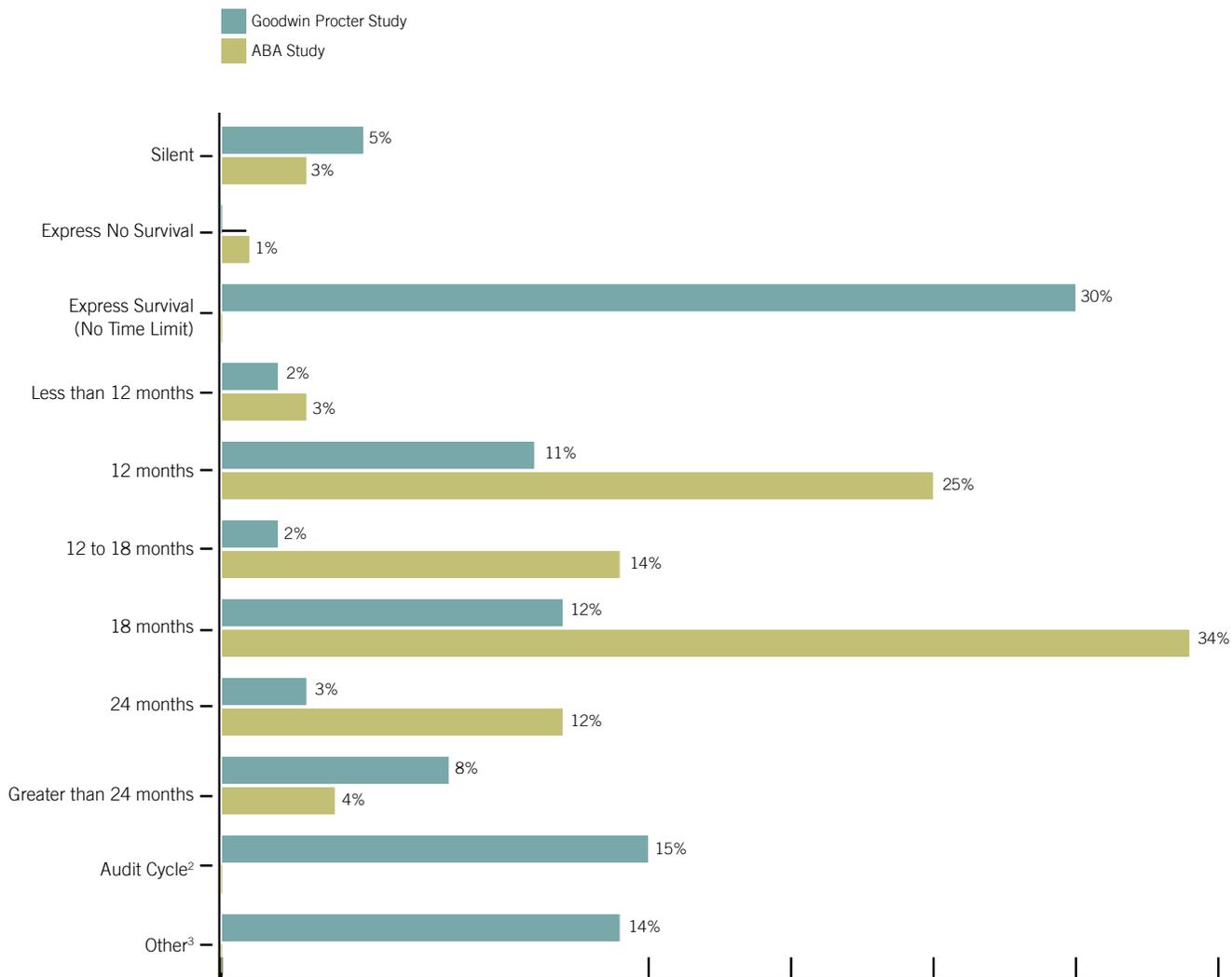
### Express Survival with No Time Limitation

“The representations and warranties of the Company and the Investors contained in or made pursuant to this Agreement shall survive the execution and delivery of this Agreement and the Closing.”

### Express Survival with Time Limitation

“All of the representations and warranties contained in this Agreement shall continue until the eighteen (18) month anniversary of the Closing (such eighteen (18) months are referred to as the “period of survival”), except for the representations and warranties contained in Section 2.1 (Organization and Corporate Power), Section 2.2(a) (Authority), Section 2.4 (Capitalization) and Section 2.12 (Tax Matters), which in each case shall continue until sixty (60) days following the expiration of the applicable statute of limitations (including any extensions thereto)...”

## Survival Period<sup>1</sup>



<sup>1</sup>These periods apply to most representations and warranties. Certain representations and warranties may be carved out from these periods in order to survive for other specified periods.

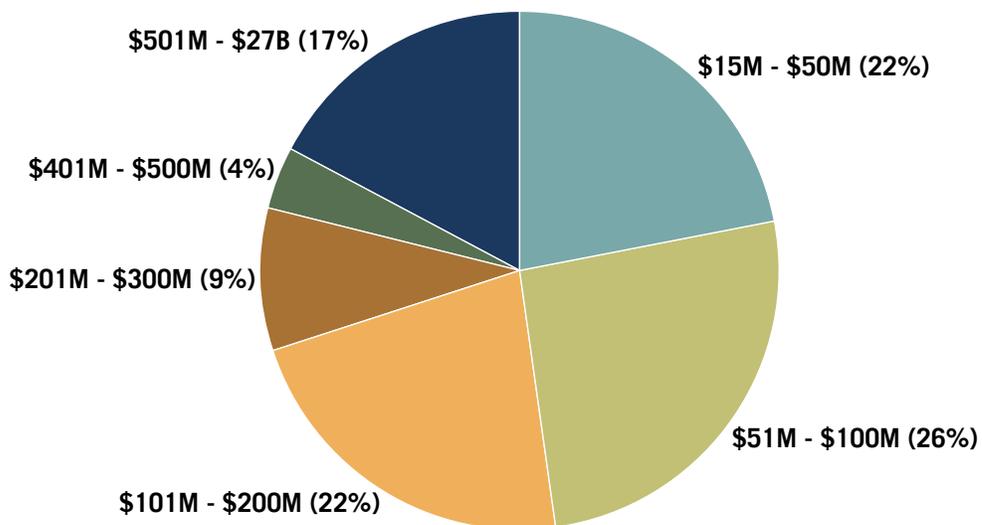
<sup>2</sup>Refers to deals in which the survival period was tied to the delivery of audited financial statements of the target company for one or more audit cycles.

<sup>3</sup>Includes, for example, deals that provide for survival until the consummation of a qualified initial public offering or sale of the company.

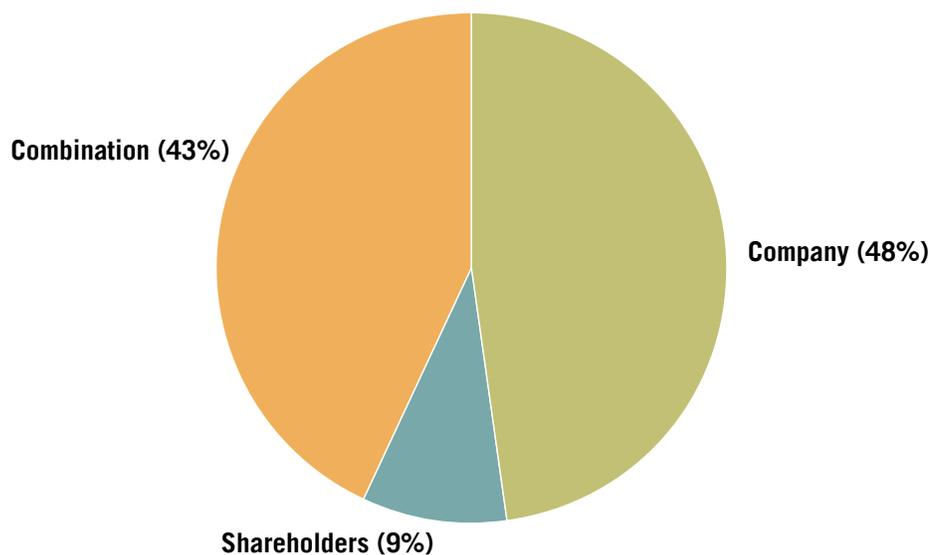
## SPOTLIGHT: DEALS WITH NO SURVIVAL PERIOD LIMITS

We analyzed the 35% of deals that did not include a limit on the survival period of the representations and warranties to determine: (1) were they concentrated within a certain band of equity values of the target company and (2) who received the proceeds in those deals.

### Equity Value of the Target Company



### Receipt of Proceeds



# BASKETS

## Sample Provisions

### Deductible

“Company Indemnified Parties shall not be required to indemnify Investor Indemnified Parties for Losses until the aggregate amount of all such Losses exceeds \$300,000 (the “Deductible”), in which event the Company Indemnified Parties shall be responsible only for Losses exceeding the Deductible.”

### First Dollar

“Company Indemnified Parties shall not be required to indemnify Investor Indemnified Parties for Losses until the aggregate amount of all such Losses exceeds \$500,000 (the “Threshold”), in which event the Company Indemnified Parties shall be responsible for the aggregate amount of all Losses, regardless of the Threshold.”

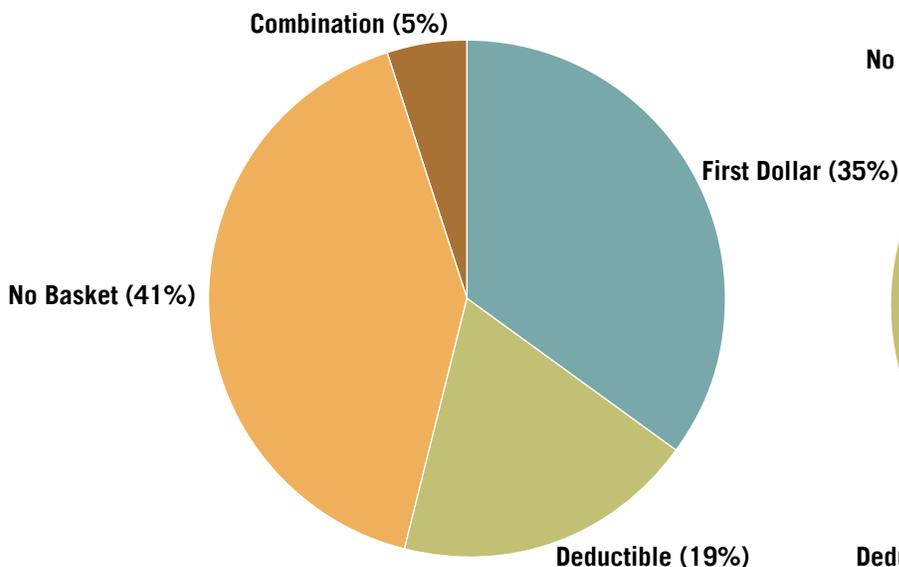
### Combination

“Company Indemnified Parties shall not be required to indemnify Investor Indemnified Parties for Losses until the aggregate amount of all such Losses exceeds \$500,000 (the “Threshold”), in which event the Company Indemnified Parties shall be responsible only for Losses in excess of \$300,000 (the “Deductible”).”

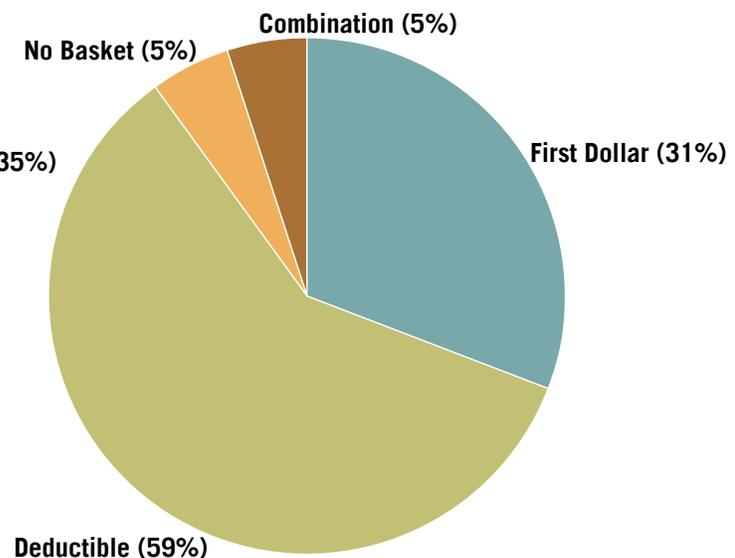
## BASKETS: TYPE

### Subset: Deals with Survival Provisions

Goodwin Procter Study

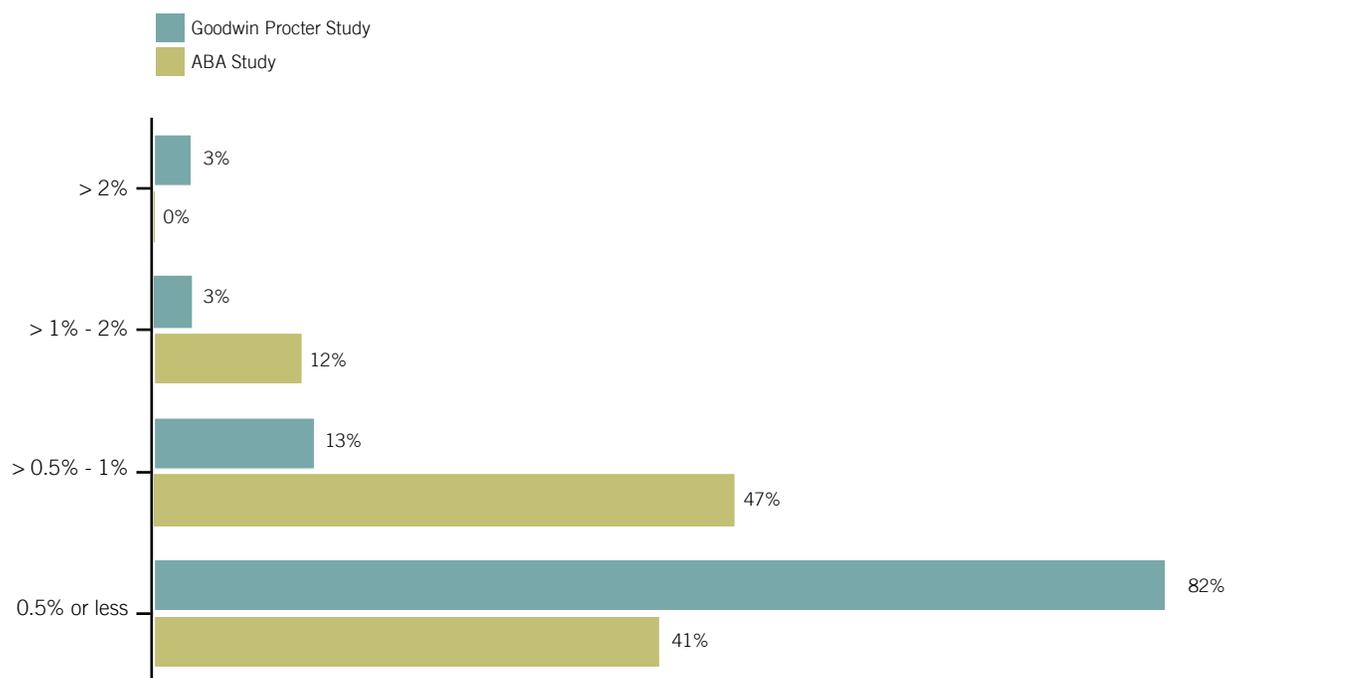


ABA Study



# BASKETS AS % OF EQUITY VALUE<sup>1</sup>

## Subset: Deals with Baskets



<sup>1</sup>Note that the ABA Study data presented here represent percentages of acquisition transaction values for comparison with our data based on percentages of equity values.

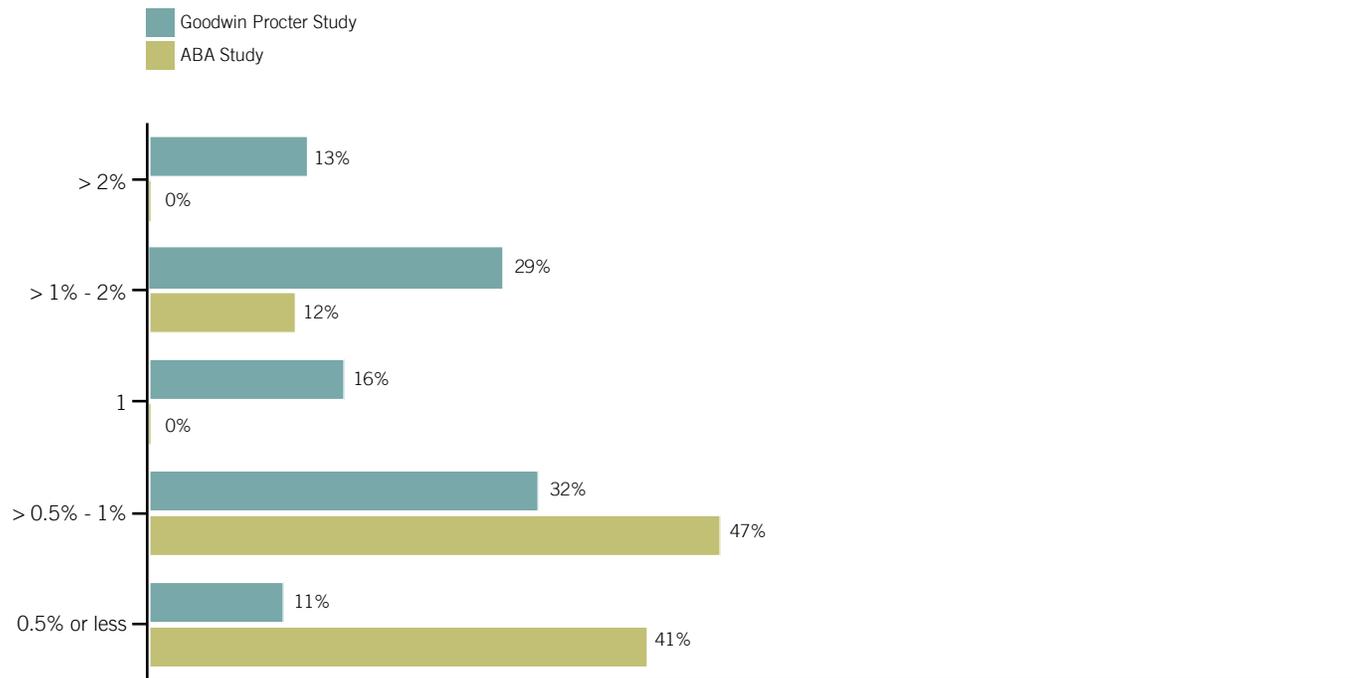
# BASKETS AS % OF EQUITY VALUE: STATISTICAL SUMMARY

## Subset: Deals with Baskets

Basket Type	Mean	Median	Minimum (>0)	Maximum
Deductible	0.638%	0.320%	0.084%	5.080%
First Dollar	0.338%	0.200%	0.002%	1.090%
All Baskets (other than Combination)	0.450%	0.230%	--	--

# BASKETS AS % OF INVESTMENT AMOUNT<sup>1</sup>

Subset: Deals with Baskets



<sup>1</sup>Note that the ABA Study data presented here represent percentages of acquisition transaction values for comparison with our data based on percentages of investment amounts.

## BASKETS AS % OF INVESTMENT AMOUNT: STATISTICAL SUMMARY

Subset: Deals with Baskets

Basket Type	Mean	Median	Minimum (>0)	Maximum
Deductible	1.747%	1.000%	0.556%	10.930%
First Dollar	2.483%	1.000%	0.135%	26.590%
All Baskets (other than Combination)	2.210%	1.000%	--	--

# ELIGIBLE CLAIM THRESHOLDS

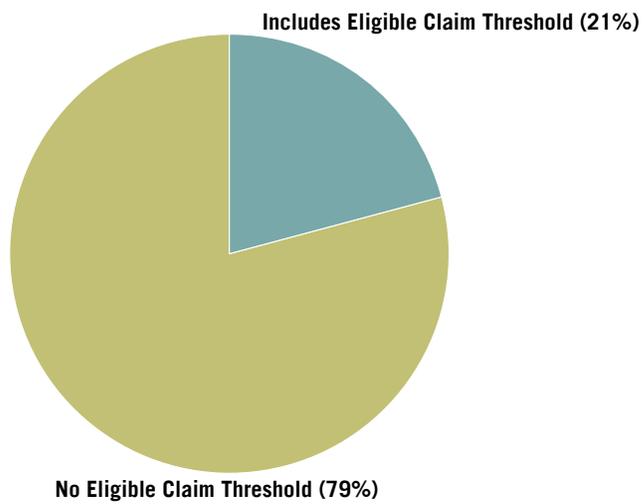
## Sample Provision

“Company Indemnified Parties shall not be required to indemnify Investor Indemnified Parties for any individual item where the Loss relating to such claim (or series of claims arising from the same or substantially similar facts or circumstances) is less than \$15,000.”

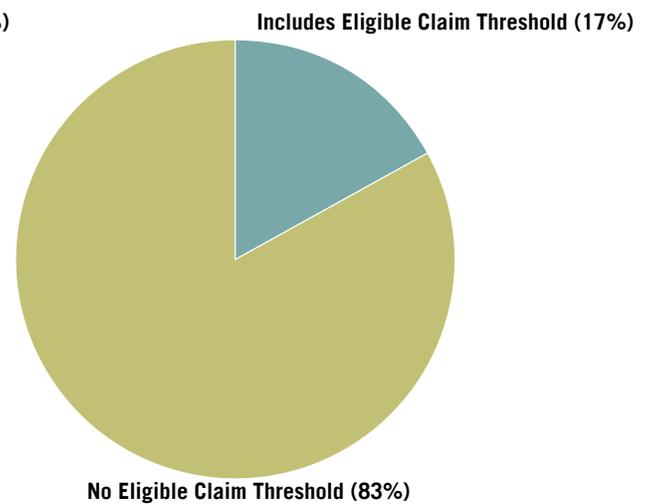
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## Subset: Deals with Baskets

### Goodwin Procter Study

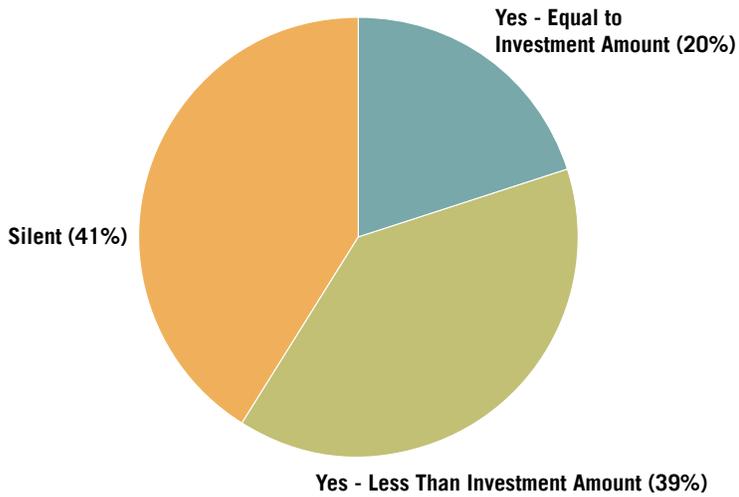


### ABA Study

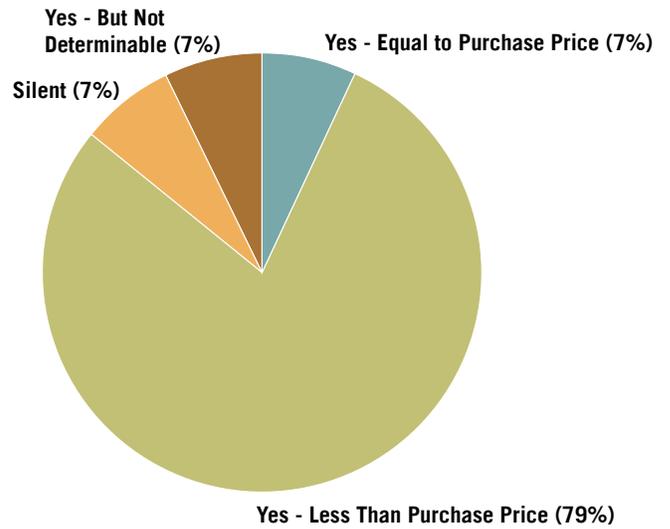


## Subset: Deals with Survival Provisions

### Goodwin Procter Study



### ABA Study

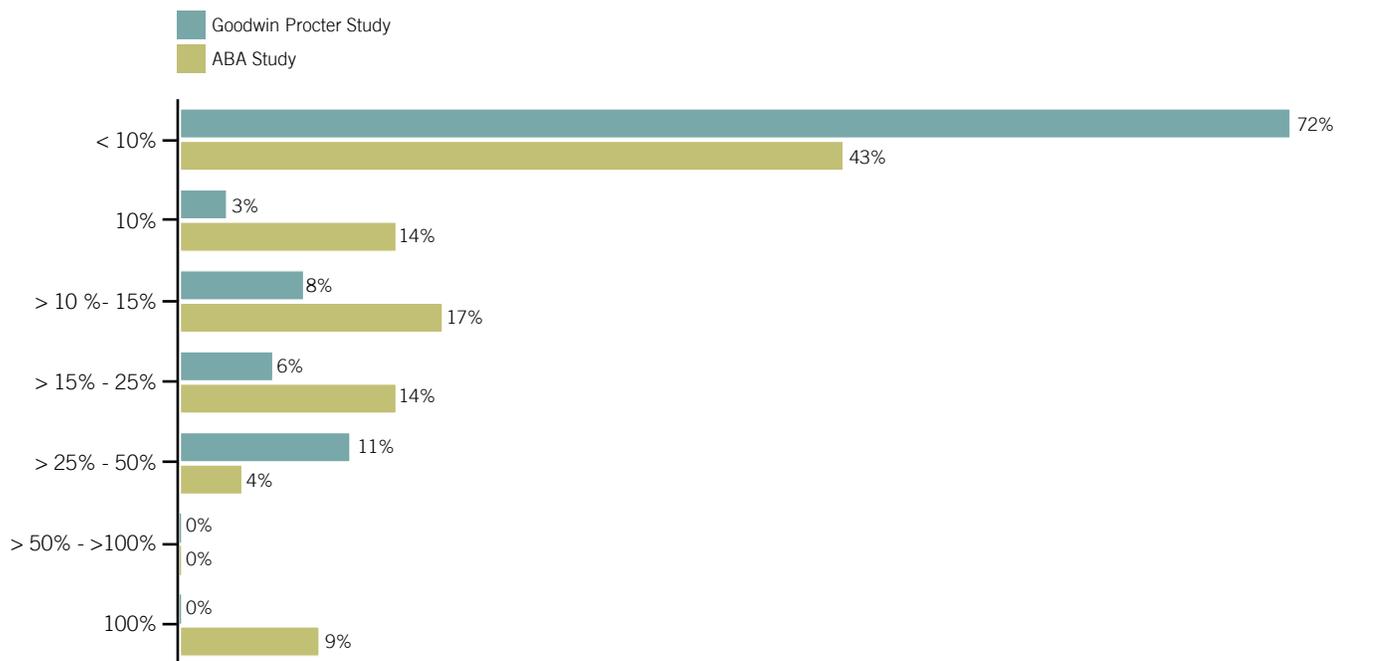


<sup>1</sup>Caps generally applicable to contractual indemnification obligations; does not take into account different caps for specific items.

# CAPS AS % OF EQUITY VALUE<sup>1</sup>

Subset: Deals with Determinable Caps<sup>2</sup>

Mean	Median	Minimum >0	Maximum
10.17%	5.70%	0.24%	46.50%



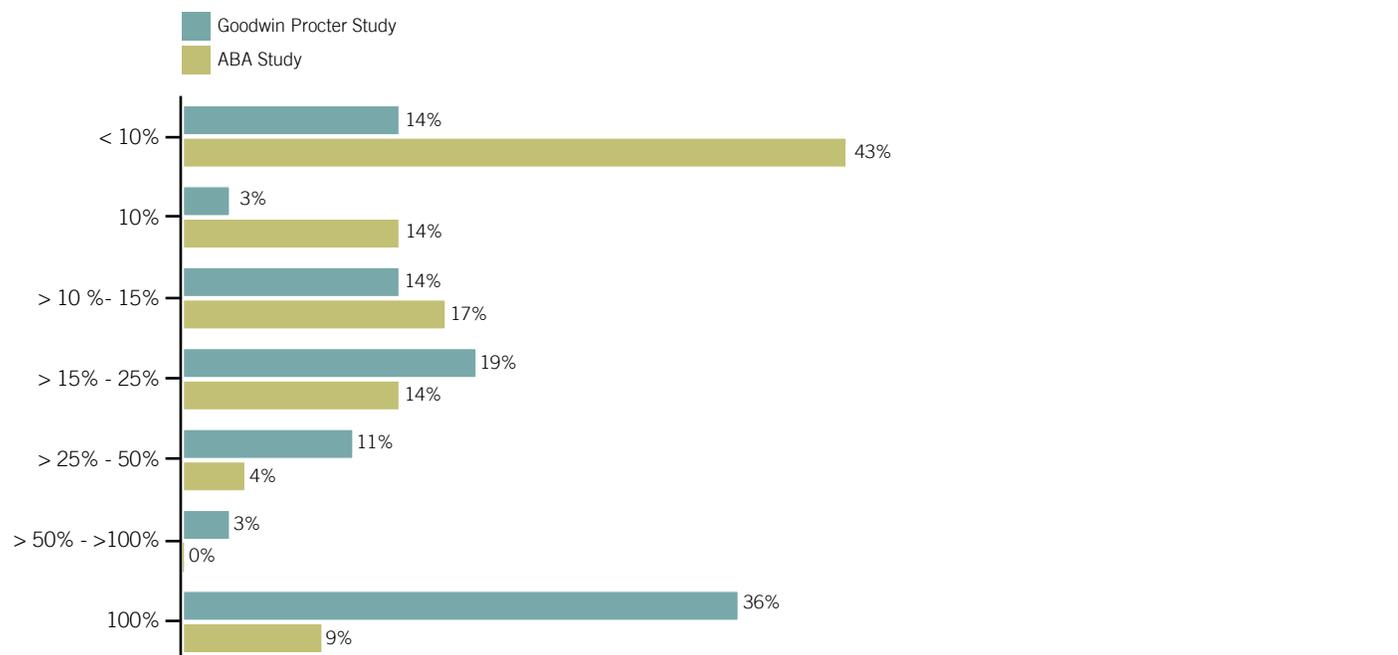
<sup>1</sup>Note that the ABA Study data presented here represent percentages of acquisition transaction values for comparison with our data based on percentages of equity values.

<sup>2</sup>Excludes three deals which contained different caps for the target company and the shareholders.

# CAPS AS % OF INVESTMENT AMOUNT<sup>1</sup>

Subset: Deals with Determinable Caps<sup>2</sup>

Mean	Median	Minimum >0	Maximum
48.75%	25.66%	5.34%	100%



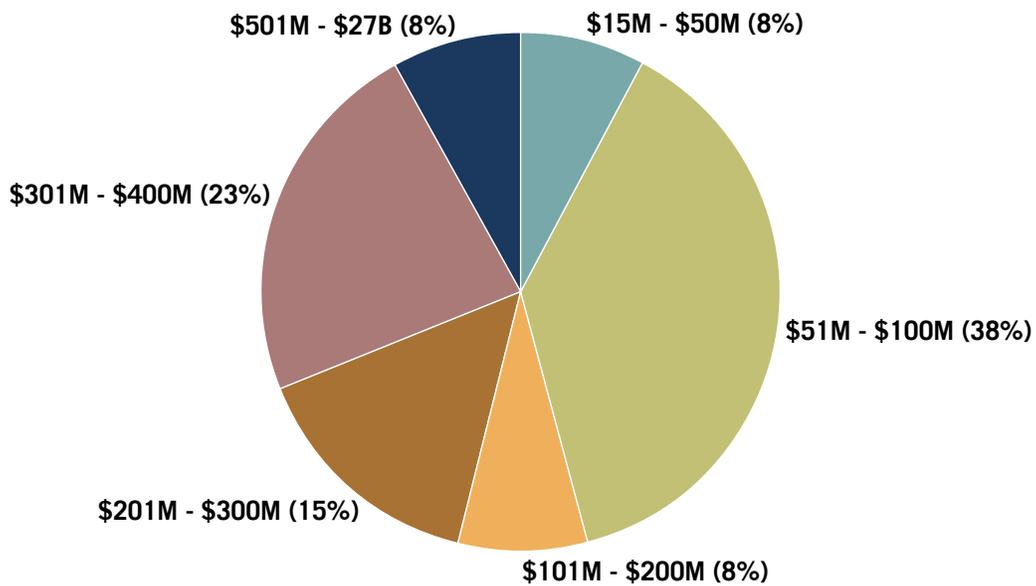
<sup>1</sup>Note that the ABA Study data presented here represent percentages of acquisition transaction values for comparison with our data based on percentages of investment amounts.

<sup>2</sup>Excludes three deals which contained different caps for the target company and the shareholders.

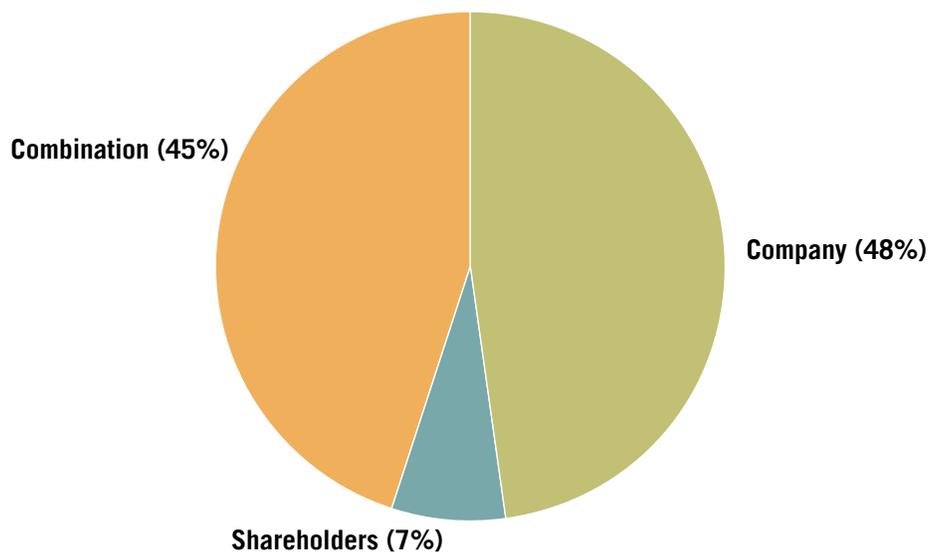
## SPOTLIGHT: DEALS WITH CAPS EQUAL TO THE FULL INVESTMENT AMOUNT

We analyzed the 36% of deals with caps that were equal to the full investment amount to determine: (1) were they concentrated within a certain band of equity values of the target company and (2) who received the proceeds in those deals.

### Equity Value of the Target Company



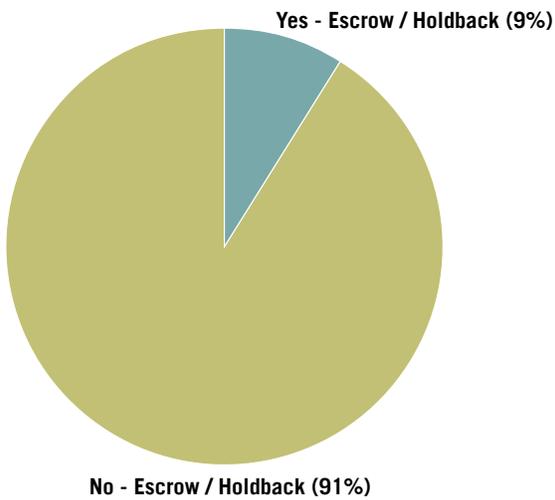
### Receipt of Proceeds



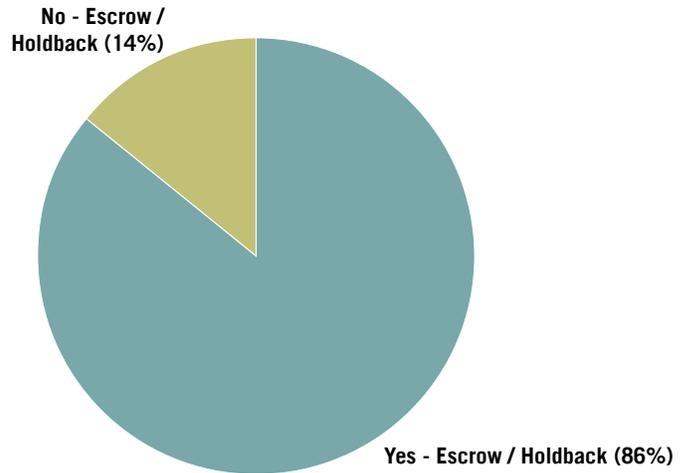
# ESCROWS / HOLDBACKS

Subset: Deals with Survival Provisions

Goodwin Procter Study



ABA Study



## ESCROW AS % OF EQUITY VALUE

Subset: Deals with Escrows / Holdbacks

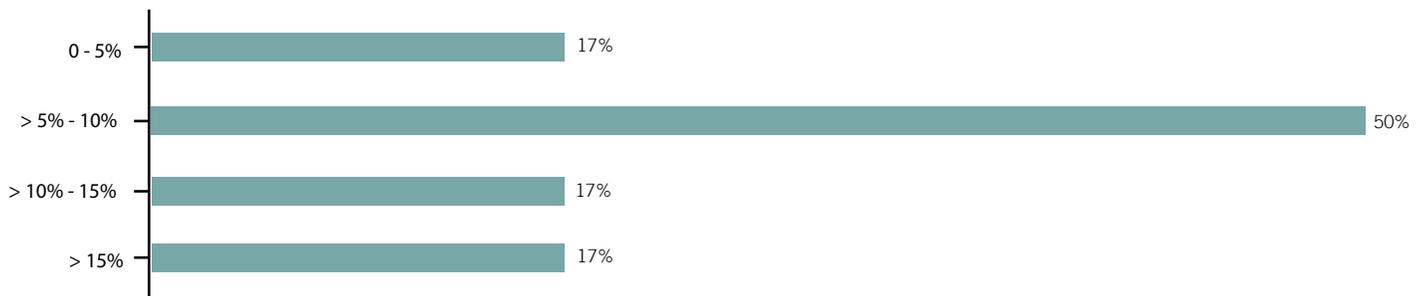
Mean	Median	Minimum >0	Maximum
3.56%	3.74%	0.86%	5.71%



## ESCROW AS % OF INVESTMENT AMOUNT

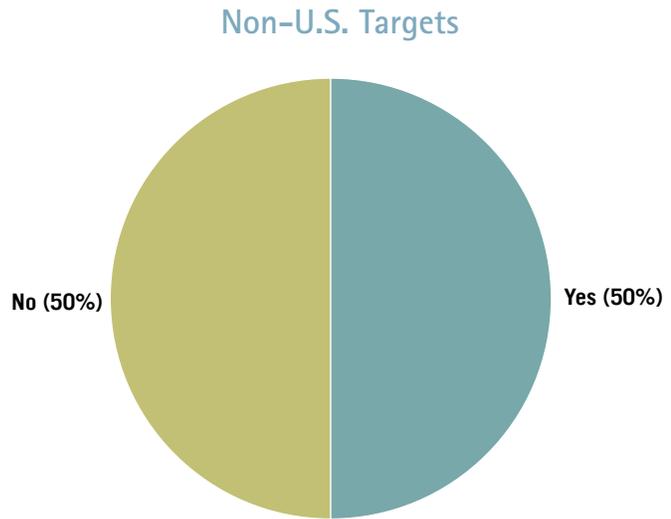
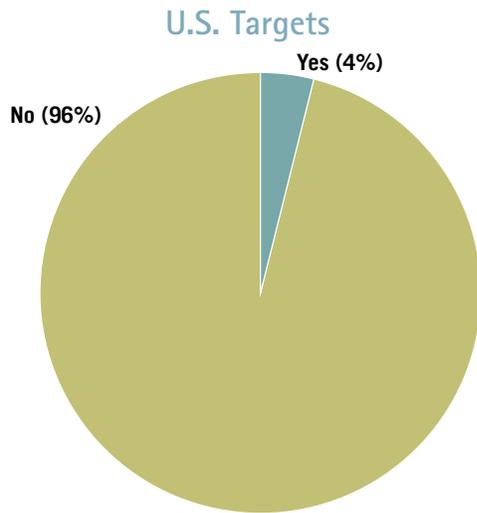
Subset: Deals with Escrows / Holdbacks

Mean	Median	Minimum >0	Maximum
9.20%	8.33%	2.63%	17.14%

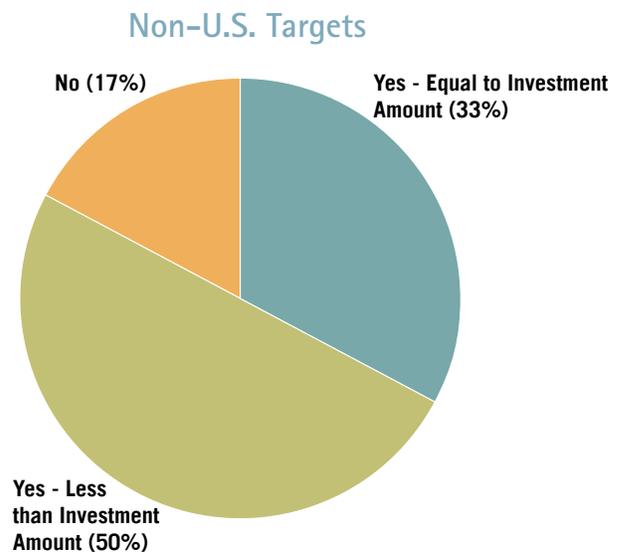
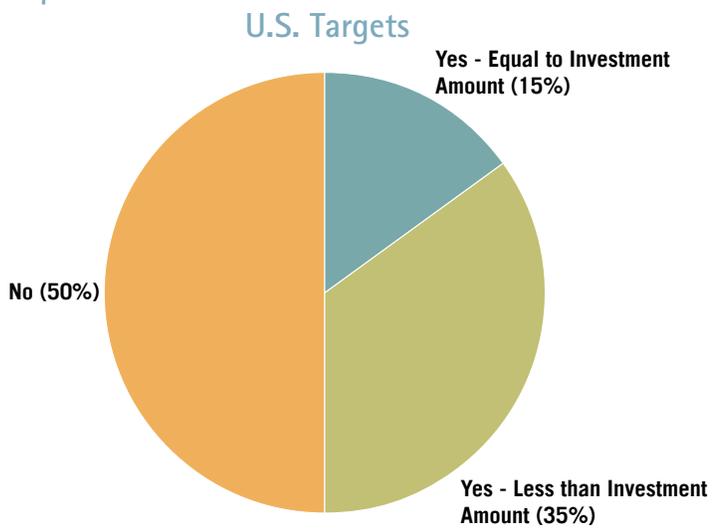


# INTERNATIONAL TAKEAWAYS

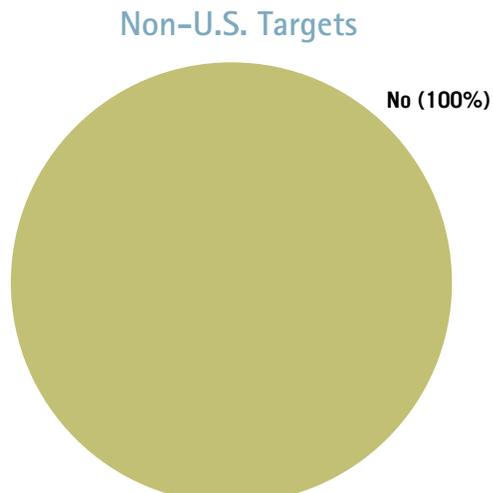
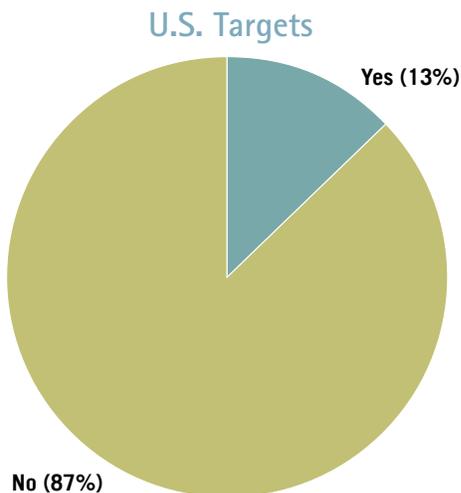
## Eligible Claim Thresholds



## Caps



## Escrows / Holdbacks



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## About Growth Equity Practice

Goodwin Procter's industry-leading Growth Equity Practice offers a blend of sector and stage experience for companies and investors. With the dynamic changes affecting the credit markets in recent years, investing activity has increasingly shifted toward the growth equity sector – capital infusions that are less reliant on leverage and that tend to straddle aspects of buyouts and venture capital. As a result of extensive experience over several decades, Goodwin Procter is uniquely positioned to serve investors and companies in this variable and growing sector.

Our experience spans the entire breadth of growth equity transactions, including pass-throughs and late stage liquidity events (primaries, direct secondaries, private tender offers, dividend recaps and redemptions), across a variety of industries and global jurisdictions. More expert at handling complex, large-scale transactions than typical venture capital law firms and more adept at working in entrepreneurial growth situations than buyout law firms, Goodwin Procter offers unique expertise in the growth equity sector.

Goodwin Procter is consistently named among the nation's top law firms in the private equity and venture capital sectors by a variety of leading industry publications including *Private Equity Analyst*, *Buyouts Magazine*, *VentureSource*, *Chambers USA*, *U.S. News-Best Lawyers* and *Legal 500*. We are one of the most active law firms in the United States, having handled over 1,600 private equity, growth equity and venture capital transactions over the past two years.

## About Goodwin Procter

Goodwin Procter LLP is one of the nation's leading law firms, with offices in Boston, Hong Kong, London, Los Angeles, New York, San Diego, San Francisco, Silicon Valley and Washington, D.C. The firm provides corporate law and litigation services, with a focus on matters involving private equity; technology companies; real estate, REITs and real estate capital markets; financial institutions; intellectual property; products liability and mass torts; and securities litigation and white collar defense. For more information, visit [www.goodwinprocter.com](http://www.goodwinprocter.com). Follow us on Twitter @GoodwinProcter.

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