

T&E - Tax Alert September 15, 2008

Baldwin v. Bader et al., U.S. District Court for the District of Maine filed July 23, 2008
[Magistrate Judge John H. Rich, III.]

The issues decided in this matter ring a familiar tone with many private companies: an insolvent business obtains a loan offer contingent on the support of the unconditional guarantees of all its directors. One director balks, asking for compensation for his risk. The remaining directors decide to issue additional shares to the directors who provide guarantees; the formula agreed upon for additional shares to guarantors is based primarily on a since-withdrawn equity offer of 10% of the capital for \$200K since the guarantors are facing a quasi-equity level risk. The balking director decides not to participate, and his equity gets diluted.

After the company recovers financially several years later, a larger financing with a financial institution is agreed upon by the directors, again conditioned by all directors' personal guarantees. The board again issues additional shares to the guaranteeing directors based on the same valuation formula. The same shareholder, again, does not participate, then sues, as the board action has reduced his investment to practically nothing. What is the value of a personal guarantee, particularly when the underlying business is close to liquidation safe for more financing, which by itself may or may not facilitate a turnaround ?

This lengthy decision, applying Delaware law, discusses most of what is known about the value of guarantees, including just published valuation texts. The judge concluded that the methodology used by the defendants' to value the company in its time of hardship was as good as could be found at the time. However, the Court faulted the directors for using the same valuation years later after the company had righted itself out. So a third round of this case is all but assured to decide damages.

The decision can be found at:
http://www.med.uscourts.gov/opinions/rich/2008/jhr_07233007_2-07cv46_baldwin_v_bader.pdf.
[Please note the 5 underscores after the Judge's initials, before and after the case number and between the litigants' names.] A copy has been placed on my practice's website at
<http://www.NYNJCT-BV.com/baldwin-bader.pdf>

Do not hesitate to call or e-mail to discuss this or any other business valuation issue.

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