

Presentation

Liquidation Alternatives for the Venture-Backed Company

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CALLING MR. WOLF: LIQUIDATION ALTERNATIVES FOR THE VENTURE-BACKED COMPANY

- Silicon Valley is a well-spring of innovation and a generator of new enterprises. **BUT** the other and statistically greater “output” of this generator is the failed enterprise. For every new start-up that achieves “success,” a multitude of other start-ups will fail. Silicon Valley is thus a steady generator of failed ventures that must be liquidated.
- Venture fund managers, lenders and other investors will not spend unnecessary resources – time, money or attention – on failed ventures. These failed ventures must be liquidated with a “Mr. Wolf” efficacy.

PRELIMINARY CONSIDERATIONS FOR ANY LIQUIDATION:

- Amounts for which directors/officers might be held liable
 - employee wages and compensation
 - ERISA plan liabilities (typically 401(k) contributions)
 - withholding taxes

- Amounts due to governmental agencies
 - In any liquidation other than a federal bankruptcy case, amounts due the federal and state governments have a first priority
 - For federal priority, it is any amount due a US government agency, not just taxes
 - California has a similar priority, but California priority is subordinate to certain wage priorities

- Amounts due employees/contractors
 - actual wages
 - benefits
 - 401(k) withholdings/payments

- Assets to be liquidated
 - Are the assets of a nature that a disposition requires critical support from key employees?
 - Are there any potentially toxic assets?
 - Do assets require specialized care to preserve (e.g. databases, medicines, sensitive chemical compounds, highly toxic compounds)?
 - Can the assets be “moth-balled” without material deterioration in realizable values?

➤ Secured Creditors

- Fully or partially secured?
- Do secured creditors want control of process or do they want someone to manage the disposition?
- How many secured creditors are there and how do they relate to one another and to the Company?
- What is the Company's leverage: what does the secured creditor need in terms of cooperation and support to maximize recovery?

➤ Management Team Attitude

- Is there an interest in a restart?
- Is any of management team willing to see a disposition through or just ready to turn over the keys and move on?
- Does management team have skill set and temperament to deal with a liquidation?

➤ Material Liabilities that May Be Capped in a Bankruptcy Proceeding

- Are there significant real estate lease and employment contract liabilities?
- The ability to significantly cap these liabilities in a bankruptcy case can be significant negotiating leverage

➤ Avoidable Transactions

- Are there transactions that could be "avoided" or "unwound" that are significant enough such that the risk of avoidance represents material leverage?

LIQUIDATION ALTERNATIVES

1. Shutdown Without Formal Dissolution
2. Formal Dissolution
3. Consensual Foreclosure
4. Liquidation Director Liquidation
5. Assignment for the Benefit of Creditors
6. Chapter 7 Bankruptcy
7. Chapter 11 Bankruptcy

OVERVIEW OF THE ALTERNATIVES

Alternative 1

Shutdown by Liquidation Management Team Without Formal Dissolution

Skeletal management team (the “Liquidation Management Team”) terminates employees, sells assets, and distributes proceeds in accordance with priorities. The Board of Directors (“BOD”) gives a final set of resolutions to authorize the Liquidation Management Team to liquidate assets and distribute proceeds (and even file bankruptcy if deemed appropriate in response to unforeseen developments). Insolvency counsel prepares creditor letter explaining the cessation of operations and the liquidation and distribution of proceeds (the “Creditor Disclosure Letter”). The Creditor Disclosure Letter should disclose if any assets are transferred to insiders or amounts are paid to insiders. The corporation/LLC remains a non-operating shell and no further action is taken: failure to pay franchise taxes ultimately causes entity to no longer be in good standing and entity cannot appear and defend in legal actions.

Alternative 2

Shutdown by Liquidation Management Team With Formal Dissolution

Just as in Alternative 1, the Liquidation Management Team terminates employees, liquidates assets and distributes proceeds in accordance with priorities. The Company then files a certificate of dissolution which will also trigger a requirement that the Company notify creditors of a deadline to make a claim against Company. While not required, it is highly advisable for the Company to send a Creditor Disclosure Letter with the notice (and explain that there are no further assets for distribution).

Formal dissolution does not require that all creditors be paid. The Company will, however, have to file a final state tax return and pay the final franchise tax to complete the formal dissolution.

Alternative 3

Consensual Foreclosure

Assuming a secured creditor with blanket lien, the Company cooperates with secured creditor in the foreclosure sale of the assets, in some cases in consideration of the secured creditor agreeing to make a portion of the sale proceeds available to pay liabilities. The Company terminates all employees; the secured creditor makes appropriate retention arrangement for those employees it deems “key” to realizing the value of its collateral.

The Company may enter into a “Peaceful Foreclosure Agreement” confirming access to property, waiver of defaults and notices and providing certain representations and warranties to support the secured creditor’s sale or other disposition of the collateral. Following foreclosure, the Company sends a Creditor Disclosure Letter to creditors explaining that secured creditor with a valid perfected security interest foreclosed on the Company’s assets and there are no assets with any distribution value and no purpose would be served by initiating a bankruptcy proceeding. The corporation/LLC remains a non-operating shell and no further action is taken.

Alternative 4

The Liquidation Director/Member Liquidation

Board appoints a “liquidation director” to Board. Concurrently, the holders of more than a majority of the outstanding shares transfer their stock to the liquidation director or a related entity. Once shares are transferred, directors other than the liquidation director resign. Result is that liquidation director is both sole director and controls the vote of majority of shareholders.

The liquidating director liquidates the Company’s assets and distributes proceeds and issues a Creditor Disclosure Letter with the liquidation results. Liquidation director presumably permits Company to default on franchise taxes and Company

ultimately fails to remain in good standing with same consequences as in Alternative 1. As an alternative, Board could negotiate for the liquidation director to follow up with a dissolution certificate to effect a formal dissolution.

Alternative 5

Assignment for the Benefit of Creditors

The Company transfers substantially all of its assets to an “assignee” by means of a general assignment for benefit of creditors (“ABC”). In many cases, the Company will actually negotiate the terms of a sale of substantially all of the assets in advance of the assignment and leave it to the assignee to close the transaction. Once the ABC is effected (a matter of contract), all of the Company’s transferable property belongs to the assignee and the assignee disposes of such property consistent with its duties without further consent of the debtor. Assignee will give notice of assignment and bar date for claims against available funds.

The assignment only transfers property subject to enforcement of a money judgment: it does not formally wind up and dissolve the entity. Since the corporate shell with all of its shareholders remains intact, the Company may want to consider a follow up dissolution, although such follow up is not typical.

Alternative 6

Chapter 7 Bankruptcy

The Company’s management, with the assistance/advice of bankruptcy counsel, prepares detailed schedules of assets and liabilities as well as an extensive “Statement of Financial Affairs” (this will involve processing a significant amount of paper work, including a mailing list of all actual and potential creditors. financial statements and tax returns for up to 3 years, as well detail on all payments within (1) 90 days of the filing and (2) 1 year for “insiders”).

With the above documentation completed, the Company secures the physical facilities and files the bankruptcy petition. Once the petition is filed, a Chapter 7 trustee assumes all control over the Company's assets and is responsible for the liquidation of those assets and making distributions. A member of the management team designated as the "responsible person" must appear at a "341 meeting" and answer the Chapter 7 trustee's questions concerning the Company and the information in the schedules and statement of financial affairs.

While there is a legal duty to cooperate with the Chapter 7 trustee in the performance of his/her duties, such legal duty is typically deemed satisfied by appearance at the 341 meeting coupled with turning over all possession/access to Company assets to the Chapter 7 trustee.

Chapter 7 should be considered as a "toss the keys to someone else" alternative. That does not sound elegant, but it is appropriate in many circumstances.

Alternative 7

Chapter 11 Bankruptcy

BOD authorizes Chapter 11 petition. In addition to the initial financial disclosures (Schedules and Statement of Financial Affairs), any significant action by the Company (e.g. financing or disposition of assets) will require Court approval with concomitant legal expense and delay. Chapter 11 is a solution for (i) an enterprise with substantial going concern value with a healthy income statement but an inverted balance sheet or (ii) an enterprise with a balance sheet sufficiently large such that anything short of the formal bankruptcy proceedings becomes untenable. The failed Silicon Valley start-up rarely qualifies for Chapter 11 treatment.

MATRIX FOR EVALUATION OF LIQUIDATION ALTERNATIVES

Criteria For Evaluation Alternatives	Informal Shutdown	Shutdown with Formal Dissolution	Consensual Foreclosure	Liquidation Director	ABC	Chapter 7
Expense *Does not include compensation to management team	\$5,000 to \$10,000*	\$10,000 to \$15,000*	\$5,000 to \$10,000*	\$50,000* (plus a percentage of distribution proceeds)	\$20,000 (low) to \$75,000* (plus a percentage of distribution proceeds)	\$10,000 to \$15,000*
Required Corporate Authorization	Board of Directors and Majority of Shareholders	Board of Directors and Majority of Shareholders	Board of Directors [not even Board of Directors depending on structure]	Board of Directors and Majority of Shareholders	Board of Directors and Majority of Shareholders	Board of Directors
Management/Board Control Over Process	High	High	Medium	Medium to High	Medium	Low
Stay on Creditor/ Shareholder Actions	Low	Low	Low	Low	Low	Medium
Time to Close a Transaction	Immediate	Immediate	Short [can be immediate with appropriate waivers]	Immediate	Immediate to Medium (most ABCs involve an immediate transfer)	Assume 90+ days

MATRIX FOR EVALUATION OF LIQUIDATION ALTERNATIVES

Criteria For Evaluation Alternatives	Informal Shutdown	Shutdown with Formal Dissolution	Consensual Foreclosure	Liquidation Director	ABC	Chapter 7
Time to Final Conclusion	Short Term	Short Term	Short Term	Short to Longer Term	Longer Term	Long Term
Capacity to Deal with Claims of Dissident Creditors and/or Shareholders	Low	Low	High	Relatively High	Medium	High
Probability of Derivative Causes of Action Being Pursued Against D&Os	Low	Low	Low	Low	Low	Medium to High
Capacity/Authority to Dispose of Assets in non-CA Jurisdiction	High	High	High	High	Medium	High
Capacity to Transfer IP Centric Assets	Medium to High	Medium to High	Low	Medium to High	Medium	Low to Medium
S-K Disclosure Event	No	No	No	No	Yes	Yes
Loss of Company Attorney-Client and Work Product Privileges	No	No	No	No (so long as secured creditors do not foreclose on privileged documents)	Uncertain	Yes

MATRIX FOR EVALUATION OF LIQUIDATION ALTERNATIVES

Criteria For Evaluation Alternatives	Informal Shutdown	Shutdown with Formal Dissolution	Consensual Foreclosure	Liquidation Director	ABC	Chapter 7
Application of Bulk Sale Laws [note that bulk sale laws generally only apply to entities in the business of selling inventory]	Possible	Possible	No	Possible	No	No
Will creditors be sued on avoidable transfers	No	No	No	No	Yes	Yes
Can real estate lease and employment contract claims be capped?	No	No	No	No	No	Yes
Finality: Can determined Creditors/Shareholders revisit?	Yes	Yes	Limited	Yes	Yes	No

Considering the Matrix:

- There is no one “best solution” for liquidation: it is highly dependent on the circumstances. Do not attempt to assign an absolute value to each of the criterion: the values vary significantly on the circumstances.
- Lawyers typically do not appreciate the “nuts and bolts” of operational issues associated with a liquidation – it is “never as simple as it seems”.



Failed venture companies need a “Mr. Wolf” approach.

Vectis Law Group will provide all of the resources necessary to resolve Silicon Valley liquidation: that is a “Mr. Wolf” commitment.