



## On the Brink of Insolvency: What Companies Need to Know and Their Alternatives to Bankruptcy

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### Meet the Speakers



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## Program Overview

- **I. What Executives Should Know**
- **II. Alternatives to Bankruptcy**
- **III. Main Takeaways**

## Fiduciary Duties of the Board of Directors

- **What is a director's fiduciary duty?**
- **The business judgment rule**
- **To whom do directors owe fiduciary duties?**
- **When is a corporation insolvent? The independent tort of "deepening insolvency."**

## Hypothetical Scenario “Company D” (Distress)

- Company D has raised capital in two rounds – a seed round that raised \$1M from angel investors, and a Series A Preferred round that raised \$5M from institutional/VC investors
- Company D has developed a technology platform that would allow medical information to synch with a wearable band that would be sold through Big Box Retailer
- With \$2M left in the bank, the board learns:
  - The CEO's initial revenue estimates for the next fiscal year were extremely optimistic
  - The technology platform has security vulnerabilities that cannot be easily resolved
  - Big Box Retailer announces that will close multiple stores; internal champion for Company D leaves Big Box Retailer
  - Big Box Retailer has a termination for convenience clause in MSA, and terminates agreement
  - Key employees, recently hired, begin to leave, saying that CEO is mercurial
- Burn is \$200K a month (meaning 10 months of cash at current staffing level)

## Warning Signs for Emerging Companies

- Six months or less of cash
- Sudden increase in costs
- Loss of a key contract or key customer
- Departure of key personnel
- Delays in development of a new product
- Product does not perform as expected and poor reception in the marketplace

## Warning Signs for Mature Companies

- Sudden drop in revenue
- Failure to obtain regulatory approval for a product
- Entry into the market of the 1000 pound gorilla
- Ethical issues

## A Problem Is Identified, Next Steps?

- Obtain a realistic understanding of the company's liabilities.
  - Look beyond the balance sheet
- Evaluate options from an operational standpoint.  
Consider:
  - Remediate operational issues
  - Reduce burn rate
  - Raise equity/debt
  - Market the company for sale
  - Bring in professionals
  - Identify individuals with the skillset for a restructuring

## A Problem Is Identified, Next Steps?

- **Evaluate options a legal standpoint**
  - Are financial resources ample to cover its statutory obligations and costs through an orderly wind down?
  - Is current management capable of managing a company in distress?
  - **Personal liability and the “Big 5”**
    - Wages (dependent on the state(s)), PTO and Severance
    - Trust Fund Taxes
    - Pension Obligations
    - Environmental Issues
    - “Catch all”
      - Credit cards
      - Personal guarantees

## Examples of Sources for Potential Personal Liability

- Unpaid Wages and Compensation Owed to Employees
- Failure to Withhold and Pay Over Federal Employee Taxes
- Willful Failure to Pay Contribution or Withholding for Unemployment, Workers' Compensation and Disability Taxes/Contributions
- Failure to Maintain Workers' Compensation Insurance
- Willful Failure to Pay Sales and Use Taxes
- Issuance of “Bad” Checks
- Unlawful Payment of Dividends
- Plan Contributions Under ERISA Plans
- Termination of a Single-Employer Plan Under ERISA
- CERCLA Responsible Party Liability
- Securities Laws
- Guaranty of Corporate Obligations
- Americans With Disabilities Act of 1990
- Perishable Agricultural Commodities Act
- Packers and Stockyards Act

## Good Practices for the Distressed Company

- **How can Board members keep themselves educated and aware?**
  - What should the Board of Company D do?
- **When Should a Board seek the advice of counsel or other professionals?**

## Factors a Board MAY Consider

- **Creditor and shareholder liabilities**
  - Understand to whom the fiduciary duty is owed
  - Comprehensively evaluate alternatives to maximize value for constituents
  - Document consideration of and efforts towards executing alternatives
- **Tax and insurance obligations**
  - Confirm status of tax and insurance payments
  - Consider insurance coverage, timing and logistics of renewals
- **Employees**
  - Ascertain the universe of employee-related obligations
  - Refrain from paying non-ordinary payments to insiders

## Business Termination Alternatives

- **Bankruptcy – Chapter 7 (Liquidation)**
- **Bankruptcy – Chapter 11 (Reorganization)**
- **Assignment for the Benefit of Creditors**
- **Foreclosure**
- **Receivership**
- **Informal Wind Down**
- **Formal Dissolution Pursuant to Delaware Corporations Code, Section 280**

## Features, Pros and Cons of Alternatives

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## ABC vs. Bankruptcy Liquidation Chapter 7 / Liquidating Chapter 11

- **Pros**
  - Court oversight – court approves significant business actions
  - Protection for Buyer –successor liability, fraudulent transfer
- **Cons**
  - Much slower than an ABC, months vs. weeks; Court must approve decisions
  - Court appointed Trustee, fear of the unknown, management/board can be scrutinized
  - Trustee may not be positioned to sell assets efficiently
  - Generally more expensive than an ABC
  - Subject to an over-bid process – risk of delay
  - Stigma of a bankruptcy



## ABC vs. Bankruptcy Liquidation Assignment for the Benefit of Creditors

- **Pros**
  - Ability to move with speed and flexibility – weeks vs. months
  - Assignee assumes risks of sale transaction (assignee, not company sells assets)
  - Generally less expensive than a bankruptcy
  - Company appointed assignee (trustee)
  - No stigma of bankruptcy; required disclosures are limited
- **Cons**
  - Limited court oversight
  - Buyer - risk of successor liability and fraudulent transfer
  - Possible conversion to bankruptcy



## Top 10 Takeaways

- **Understand fiduciary duties and to whom they are owed**
- **Be vigilant of warning signs of distress**
- **Take matters to ameliorate distress**
- **Evaluate all options to maximize benefits for constituents**
- **Obtain an understanding of how a Board's actions may inadvertently result in personal liability**
- **Document all efforts to assess and execute the most sensible alternatives**
- **Bankruptcy provisions provide substantial tools, but bankruptcy is not the only option**
- **Alternatives, such as ABCs, can provide a faster, cheaper means to an end**
- **Obtain the advice of professionals to educate Board on options**
- **DON'T WAIT!**

## Questions?