

Directorship

In its twenty-eighth year as the Authoritative Board Resource

• Executive Search • Governance Research • Consulting • Publishing • Directorship DataBank®

Directorship issues in insolvent technology companies: alternatives to maximize the value of assets for creditors



*by Roger E. Barton, Esq.
Partner
Barton Barton & Plotkin LLP*

All that remains among many of today's insolvent technology companies is debt and some sort of intellectual property (IP) that has little or no market value. As directors of such companies ponder how to wind up company affairs, options such as liquidation in bankruptcy court or a private sale of assets may be at the top of the list. Directors may, however, also be confronting offers from company insiders to license the company's IP for use in a new business venture. Frequently, the company's founders still dream of continuing the business, but in a different marketplace, perhaps with a different focus and business model. Essentially, they seek a fresh start, taking with them the company's IP and the valuable lessons learned with the millions in tuition money spent by the company's investors. An offer such as this may tempt directors, who may also be shareholders, with a ray of hope that their shares may be valuable at some point if the founder's new venture takes off. The

company's creditors, however, may be thinking otherwise. The goal may be immediate recoupment of what's left of their investment, or the ability to write off the investment. As directors consider the alternatives, while keeping a watchful eye on their fiduciary duties to creditors, it may become clear that licensing the IP to a company insider is the best decision for all parties involved. This article analyzes the issues that directors of insolvent technology companies face when considering their various wind-down options, including dealings with insiders.

You may recall reading about our troubled company Cantwin Corporation (Cantwin) in the October 2001 issue of *Directorship*. In that article, Cantwin's board members, many of whom were also VCs holding senior secured debt, wrestled with their often-competing fiduciary interests as Cantwin approached insolvency. It is now several months later and Cantwin has lost; it has ceased operations, there are

*“Likewise,
attempts to
generate some
value from the IP
in a private sale
will most
probably be
futile.”*

no revenues, and its only asset is intellectual property in the form of trademarks and software technology. Under any definition, Cantwin is “insolvent”—while the Model Business Corporation Act defines insolvency as “the inability of a corporation to pay its debts as they become due in the usual course of business,” the U.S. Bankruptcy Code defines insolvency as “a financial condition such that the sum of such entity’s debts is greater than all of such entity’s property, at a fair valuation.” As our earlier article on Cantwin explained, when a company is financially healthy, directors owe fiduciary duties of care and loyalty to the corporation and its shareholders. Once the corporation becomes insolvent, however, directors’ fiduciary duties shift to the company’s creditors.

Cantwin’s board is now contemplating several options that will determine the company’s fate: (1) put the company in the hands of a United States Trustee and liquidate under Chapter 7 of the Bankruptcy Code; (2) dissolve pursuant to state law procedures; (3) attempt to negotiate an out-of-court sale of the company’s IP; or (4) accept an offer from Cantwin’s CEO, who seeks to start a new company with his own money, to license the IP at what appears to be a bargain-basement price, but with a sizable royalty payment in the event his new business venture takes off. What does a board member do when faced with such an offer, particularly in light of the possible conflicts the offer presents between the company’s creditors and shareholders?

As the board contemplates each of these scenarios, no doubt each board member is thinking of the criticism to be levied by the company’s creditors in the event that the CEO’s venture fails, and what the shareholders will say about the financial terms of the license agreement if the venture is wildly successful. The issue thus becomes what is the best alternative for Cantwin’s board to deliver value to the creditors first and the shareholders second.

Liquidation, dissolution or private sale

Cantwin’s board could satisfy its fiduciary responsibilities to creditors by filing for bankruptcy relief under Chapter 7 of the Bankruptcy Code and allow a U.S. Trustee to liquidate the company’s assets and distribute the proceeds. However, in Cantwin’s case, as is the case with many of today’s technology companies, its only asset is its IP, which is probably valueless.

In such a case, where property is of insubstantial or no value such that upon liquidation there will be little or no proceeds for distribution to general creditors, a trustee may decide that the expense of collecting, preserving and disposing of it may outweigh any benefit to the estate. Under these circumstances, it makes no sense to require the trustee to administer the property. As such, 11 U.S.C. § 554 provides trustees with the power to abandon estate property; the typical effect of which is that the property is abandoned to the debtor as if the bankruptcy case was never commenced. Because corporate debtors are incapable of receiving a discharge of debts under Chapter 7, Cantwin (and its creditors) are essentially back where they started.

Cantwin’s creditors would not necessarily be in a better position if the board sought to dissolve the company under state law dissolution procedures. Under Delaware law, after a dissolution occurs (in either a non-judicial or judicial context), a corporation is required to wind up its affairs by collecting and selling its assets and then distributing the proceeds to creditors. Any assets remaining after such attempts at sale revert to the company’s shareholders, who are said to hold the assets in trust for the benefit of creditors, and who remain jointly and severally liable to existing creditors of the corporation. In Cantwin’s case, if we assume the IP is not saleable, creditors will similarly receive nothing.

Likewise, attempts to generate some value from the IP in a private sale will most probably be futile. The days of the

dot-com market, wherein Cantwin's IP commanded a valuation in the stratosphere, are long gone, making it highly unlikely that the board would find a buyer.

Licensing to insiders

If value maximization is the board's objective, based on the above, it appears as though licensing the IP to the CEO is the only real alternative. Assuming that the IP is valueless to everyone except the CEO, if the board, after a commercially reasonable investigation, determines there are no other buyers and/or licensors who are interested in the IP, then a good argument can be made that the board's fiduciary duty to creditors has been satisfied. Before the board makes the decision, it should consider and rationalize the conflicting positions among shareholders and creditors. These conflicts include: (1) the differing levels of risk that the parties may be willing to take to maximize value; (2) the race between the parties to recover their investment; and (3) the incentive to liquidate versus maintaining the company as a going concern.

On the one hand, Cantwin's shareholders have every incentive to entertain the CEO's offer; even if such a project has only a slight chance of success, any chance for share appreciation is favored. Cantwin's creditors, on the other hand, may want to preserve the company's IP in a conservative way so as to ensure satisfaction of at least part of their claim. As Cantwin slips deeper into insolvency, its creditors will be motivated to demand immediate repayment for their debt before the financial condition of the company worsens and its fund to pay creditors diminishes. Cantwin's creditors might highly favor an outright sale of the IP immediately, even at a modest value, rather than license it to the CEO in the hopes that, some day, it might pay off with large royalty payments. Cantwin's shareholders, however, have nothing to lose. Because they realize Cantwin's insolvency renders their equity valueless, licensing the IP to the CEO is a win-win situation in their eyes because the upside of this investment accrues to the shareholders. Meanwhile, the creditors may or may not bear the downside. If Cantwin's

value decreases further despite the license to the CEO, the shareholders will incur no additional loss, but the creditors will suffer a further loss. This, of course, presumes that the IP has some liquidation value that will be lost as a result of the license to the CEO.

Board members who vote to approve the license agreement at the risk of a minimal loss of any remaining value in the IP should take comfort in the fact that even if creditors were to doubt the board's decision and commence an action for breach of fiduciary duty, it is unlikely such a claim would survive. The predominant cases addressing breach of fiduciary claims involve wrongful insider transactions in which directors are also shareholders or situations in which corporations are under common ownership and control. Assuming the directors of Cantwin are disinterested and judge the decision to license to the CEO without conflicts, then they do not fall within the reasoning of this line of cases.

Incidentally, in the event Cantwin should find itself in bankruptcy court somewhere down the road, perhaps because the CEO's venture was only mildly successful and the company now seeks to reorganize, the board might find some solace in a section of the Bankruptcy Code that provides for special rules if a debtor's intellectual property asset is a software license. In general, bankruptcy law is structured to allow debtors (or the trustee in control of the debtor's assets) to escape the obligations of contracts (such as the CEO's) that are a burden on the estate. The trustee does this by "rejecting" the contract. Section 365(e) of the Code was passed to limit the ability of the trustee to reject software license agreements. Enacted in response to the landmark case *Lubrizol Enterprises v. Richmond Metal*, in which a bankrupt licensor of a manufacturing process was permitted to cancel a license agreement, leaving the licensee in a very difficult position, Section 365 (e) provides licensees with the right to elect to retain certain rights in the intellectual property during the period of the licensing agreement if the trustee attempts to reject. Thus, a decision to license to the CEO might provide the added benefit of

some stability for Cantwin as a going concern.

Board actions and strategies

In light of the issues addressed above, to guard against creditors' claims of breach of fiduciary duty, directors of insolvent companies who seek to license their company's IP to insiders should consider some protective strategies during the course of entertaining such a transaction:

- Board minutes should be strictly maintained and clearly address the competing concerns among the interested parties and the reasoning upon which decisions are made. In the event that sales of assets and/or licenses are made to insiders, specific and detailed explanations should be provided as to the steps taken to search out other buyers/

licensors, the steps taken to value the assets, and the financial terms of any such arrangement.

- If board members are also creditors and shareholders, they should consider abstaining from the vote. **D**

Roger E. Barton is a partner with the New York law firm of Barton Barton & Plotkin LLP, where he specializes in litigating matters of corporate governance and procedure and advises corporations and individual board members in those areas. Mr. Barton was previously with the law firm of Sidley & Austin. The author wishes to thank Spencer Z. Baretz, Esq., who assisted in the preparation of this article.

| | |
|---|--|
|  <p>BARTON BARTON & PLOTKIN LLP</p> | <p>Barton Barton & Plotkin, LLP 420 Lexington Avenue New York, NY 10170 Tel: 212-687-6262 Fax: 212-697-3043 E-mail: rbarton@bartonesq.com</p> |
|---|--|