How to Acquire Assets & IP From A Troubled Company: Winning Strategies For Mitigating Risk

Session Moderator: David G. Barry, Managing Editor, The Venture Capital Analyst

Speakers: Bob Eisenbach, Partner, Cooley Godward LLP

Mike Kelly, Partner, Cooley Godward LLP

Steven R. Gerbsman, Managing Principal, Gerbsman Partners

Cooley Godward LLP

- National full-service law firm with technology-focused practice serving high-growth companies, and the investors and financial institutions that fund them
- Approximately 425 attorneys nationwide with deep substantive expertise across a range of legal specialties
- Represent over 2,000 clients in over 20 industries including software, communications, semiconductors and life sciences
- Extensive experience representing buyers of assets from troubled companies, as well as representation of debtors and creditors' committees
- Offices in Palo Alto; San Francisco; San Diego; Broomfield, Colorado and Reston, Virginia
- Client-oriented, team-based approach

Gerbsman Partners

Since 1980, Gerbsman Partners has focused on maximizing enterprise value for highly leveraged, under-performing, under-valued and under-capitalized companies and their Intellectual Property. Gerbsman Partners has also assisted numerous emerging growth and middle market companies develop and execute their financial and capital formation strategies, access the capital markets and provide for technology and life science strategic alliances and licensing of Intellectual Property. Gerbsman Partners provides the following services:

- Crisis/Turnaround Management
- Private Investment Banking
- Balance Sheet Restructuring
- Maximizing Value of Intellectual Property
- Domain Expertise Technology & Wireless

Gerbsman Partners has been involved in transactions totaling more than \$ 1.5 billion, in industries as diverse as:

•	te	ch	no	lo	gy	y
---	----	----	----	----	----	---

internet

manufacturing

wireless

distribution

financial services

bio-tech

- telecommunications
- natural services

software

- hotel/time share
- life sciences

apparel

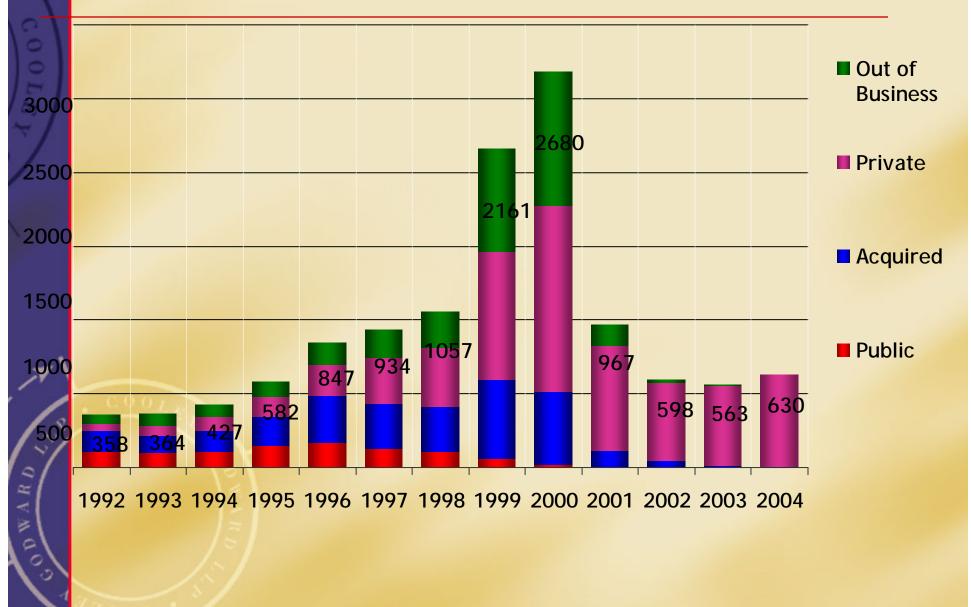
specialty retail

• gaming

We have a wealth of experience in the capacity of "Crisis Manager" as acting "CEO" and "Chief Restructuring Officer", as a member of the Board of Directors and as an Examiner for the Office of the United States Trustee.

Ownership Status by Year of Initial Financing

All Industries.... Source: VentureOne



Strategies For Acquiring Assets From A Troubled Company: How To Manage Your Risk As a Buyer

Getting into the Game

Insolvent or near-insolvent companies often present an opportunity to purchase assets at reduced cost.

A buyer purchasing assets from a troubled company wants to make sure it does not also take on the troubled company's liabilities, unless it has specifically agreed to do so.

Risks of Buying Assets From a Troubled Company

- A. Risk of fraudulent transfer claims, which can be based on:
 - Actual fraud, where the seller's transfer of assets to a buyer was actually intended to hinder, delay or defraud the seller's creditors, or
 - 2. Constructive fraud, where the transfer is deemed fraudulent if:
 - (a) the seller does not receive "reasonably equivalent value" and was insolvent or became insolvent as a result of the transfer or
 - (b) the seller did not receive "reasonably equivalent value" and either the seller's remaining assets were "unreasonably small" in relation to the business in which it was engaged or about to engage, or the seller intended to incur, or believed or reasonably should have believed that it would incur, debts beyond its ability to pay as they became due;

Risks of Buying Assets From a Troubled Company

- B. Risk of successor liability claims (e.g., if the parties achieve the results of a merger without actually merging);
- C. Risk due to limited recourse against seller (what value, if any, is there to seller's representations and warranties, to seller's agreement to provide further assurances, or to seller's agreement to indemnify for losses/breach of representations, warranties or covenants); and
- D. Risk of loss of key employees (will key employees jump ship before the deal gets done?).

The risks of an asset purchase can be significantly mitigated, either through a formal proceeding, such as bankruptcy or an assignment for the benefit of creditors (an "ABC"), or outside a formal proceeding, with appropriate due diligence and deal terms.

The right approach to an asset purchase from a troubled company depends greatly on the particular facts and circumstances of the proposed transaction.





Typical situation:

- Stakeholders/shareholders made a strategic decision that access to future capital would be limited either by the initial investment group(s) or by market conditions.
- A decision was made or implied that existing management could not take the company forward and/or there were major issues with the business model.
- The company(s) typically had 2-8 months of CASH available.
- The Board of Directors and Shareholders wanted a "Clean" exit (no formal bankruptcy, settlement of outstanding issues that demonstrate the Board is meeting/has met their fiduciary responsibilities, no potential lawsuits against" Deep Pocket" equity investors and a reduction of the significant time the Board and Shareholders were spending at/on the company).
- Board of Directors wanted to maximize the value of the Intellectual Property and other associated assets.





Example:

- Lack of hard assets.
- No senior lender or debt source.
- Young and inexperienced entrepreneurs with little or no sales, marketing, finance or operating experience.
- A business model that may not/does not focus on generating Cash or get to Cash breakeven within a reasonable time frame.
- Unavailability of capital through the equity and debt markets.
- The Equity Sponsor(s) has made the decision that they will no longer fund the company.





What is it worth?

"The Market" will determine the value

Who cares?

Customers, Competitors, and VC/Equity groups

Critical factors for success?

- Team with domain knowledge
- Relevance of the IP
- Resources and time available for Sales/M&A process
- Documented Development and Deployment Process
- Ownership and Protection





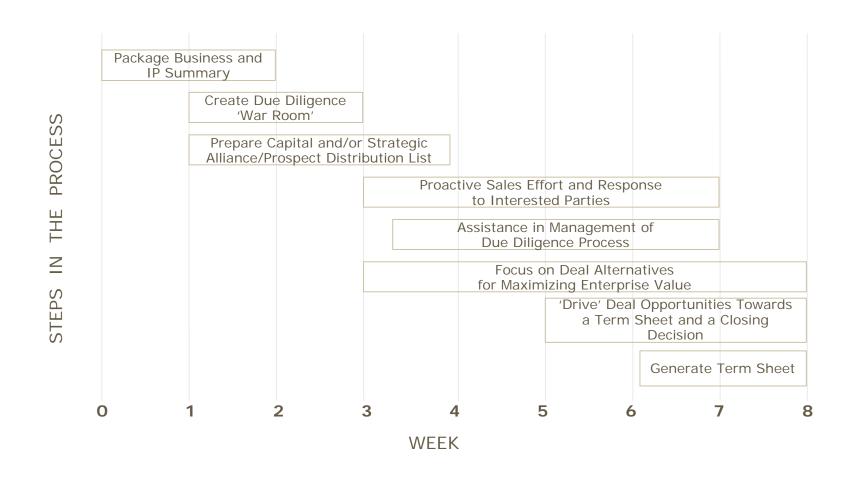
Action Plan:

- Package Business/IP Summary 3 to 6 pages sent to potential buyers
- Create due diligence "War Room"
- Phase out the use of the IP (if selling IP only and not as a going concern)
- Provide Clean Title for the prospective buyer of the Intellectual property
- Prepare Prospect / Distribution List
- Management of the process





IP – Project Timeline



Advantages of a Bankruptcy Proceeding

A debtor-in-possession ("DIP") or bankruptcy trustee may sell assets of the estate:

- By motion through a Section 363 sale
- Through a confirmed Chapter 11 plan

Advantages of a bankruptcy proceeding:

- Reduces risk of later challenges, including challenges that the transaction is a fraudulent transfer;
- Assets can be sold free of many third party liens and interests, and over objections by shareholders or unsecured creditors;

Advantages of a Bankruptcy Proceeding

- The DIP/trustee may cure and reinstate defaulted leases and executory contracts (contracts with future material obligations on both sides), and assign them to buyer over the objection of non-debtor parties, except certain intellectual property licensors;
- The DIP/trustee may reject those leases and executory contracts that neither the DIP/trustee nor buyer wants to keep, although licensees under intellectual property leases may elect to retain their IP rights under Section 365(n) of the Bankruptcy Code; and
- Once the bankruptcy court's order approving the sale becomes final, the DIP/trustee may avoid the sale only by proving collusion among potential bidders that affected the sale

Disadvantages of a Bankruptcy Proceeding

Cost

- A Chapter 11 proceeding is expensive.
- While Chapter 7 is significantly less expensive, an independent bankruptcy trustee is appointed, who is not likely to continue operating the business.
- Because the seller may not have the funds for a Chapter 11 bankruptcy proceeding, a buyer may have to consider financing the bankruptcy through a DIP loan.

Delay

- While the bankruptcy court may set expedited hearings, completing a sale often takes 30 to 60 days or more.
- The delay could increase the risk that key employees may leave, absent court approval of an appropriate employee retention plan.

Disadvantages of a Bankruptcy Proceeding

- Bankruptcy is Public
 - A bankruptcy sale is usually subject to higher and better offers, because the seller's goal is to maximize value for the estate.
 - Generally, the DIP/trustee will sell to the highest bidder, unless there is an important reason to accept a lower offer, and a creditors' committee may also weigh in on evaluating offers.
 - To address the risk of being outbid after sinking time and money into a deal as a "stalking horse bidder," a buyer may seek various protections from the bankruptcy court:
 - bidding procedures
 - minimum overbid protection
 - breakup or topping fee (buyer receives a percentage of the difference between its bid and winning bid)
 - no-shop provisions (precluding seller from shopping deal to other bidders)
 - reimbursement of expenses

Disadvantages of a Bankruptcy Proceeding

IP Issues

- A bankruptcy filing itself could cause the seller to lose rights under in-licenses of patents or copyrights.
- The Ninth Circuit Court of Appeals (whose jurisdiction includes California) has held that a DIP cannot assume or assign a nonassignable patent or copyright license, absent the licensor's consent.
- Thus, obtaining any such licensors' consent becomes particularly important.

Stigma

- Management and/or the board of directors may fear that a bankruptcy will have negative consequences to the business.
- In some cases, the benefits of bankruptcy may outweigh any perceived stigma:
 - Bankruptcy can be the most effective way for a board to fulfill its fiduciary duties to creditors
 - A buyer, however, may need to convince the seller of the advantage of bankruptcy or condition the deal on a bankruptcy filing.

Assignment for the Benefit of Creditors ("ABC")

An alternative to bankruptcy is an ABC proceeding.

- In an ABC, the seller assigns its assets to an assignee for liquidation.
- The assignee is responsible for liquidating the assets and distributing the proceeds to creditors (net of its fee).
- An ABC does not give the seller the benefit of bankruptcy's automatic stay of creditor actions.
- ABC's are governed by state law and vary significantly from state to state.
- Depending on a given state's law, an ABC may or may not be an option.
- In California, ABC's have been employed successfully and are usually quicker and cheaper than a bankruptcy.
- While not absolute protection from a fraudulent transfer claim, the purchase of assets through an ABC may reduce that risk.

Flying Trapeze Without A Net: Purchasing Assets Outside a Formal Proceeding

- A buyer may opt to purchase assets without bankruptcy or an ABC.
- A private transaction has the advantage of eliminating the costs of a formal proceeding and keeping the process fully in the control of the seller and buyer.
- In addition to the risks outlined above, however, other disadvantages include:
 - The inability to obtain financing with priority over existing debt without consent of prior lenders
 - No automatic stay of hostile creditor actions
 - Inability to bind nonconsenting creditors and others
 - Bulk sales law requirements may need to be satisfied

Purchasing Assets Outside a Formal Proceeding

- Buyers may try to manage these risks in various ways, including:
 - Consider representations and warranties from seller concerning solvency and prior bids for the assets
 - ➤ Insist that there be an adequate mechanism to assure that the seller's creditors are paid and that key creditor releases are obtained as a condition to closing
 - Escrow funds as source for payment to seller's creditors or as holdback for any claims based on seller's breach of representations/warranties or any seller indemnification obligations
 - Search applicable state Uniform Commercial Code filings and U.S. Patent and Trademark Office and Copyright Office to determine creditors with liens against assets and obtain releases from such creditors as condition of closing
 - Obtain a solvency opinion from third party expert, if appropriate

Purchasing Assets Outside a Formal Proceeding

- ➤ Obtain third party appraisal of assets and/or opinion that transaction is for "reasonably equivalent value"
- Determine which of seller's employees, if any, are needed by buyer
- ➤ Obtain assignments of key contracts, including employee proprietary rights/confidentiality agreements and in-licenses (or assess likelihood of obtaining post-closing)
- Consider third party guaranty (e.g., founder/principals, directors) as to indemnity or other seller obligations

Take-Away Points

The prospect of purchasing assets from a troubled company at a discount can be tantalizing.

A prudent buyer will assess the risks posed by such a transaction, consider the bankruptcy and ABC options, and take appropriate steps to mitigate the risks involved.

Contact Info

- David Barry, Managing Editor, Dow Jones Venture Capital Analyst, Can Be Reached at (781) 304-1411 or <u>David.Barry@dowjones.com</u>
- Robert Eisenbach, Partner, Cooley Godward Can Be Reached at (415) 693-2094, or reisenbach@cooley.com
- Michael Kelly, Partner, Cooley Godward, , Can Be Reached at (415) 693-2076, or
 kelleyjm@cooley.com
- Steven Gerbsman, Managing Principal, Gerbsman Partners, Can Be Reached at (415) 456-0628, or steve@gerbsmanpartners.com