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Distressed Startups: A Bankruptcy Lawyer's Perspective

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Turmoil in the tech ecosystem and escalating sentiment that a recession in the U.S. might occur in the near-term, indicate that startups, their lenders, and investors may soon confront extreme financial challenges – and will force all stakeholders in a troubled venture to consider strategic options. Distressed startups raise a unique set of legal issues that should be considered and addressed by their stakeholders in connection with any strategic transaction. Here are a few:

- The value in most startups is overwhelmingly tied up in the company's intellectual property – patents, copyrights, and trademarks. Preserving and maximizing the value of the IP is always a top priority. However, ownership disputes regarding IP often accompany startup restructurings, with founders, employees, investors, and competitors all potentially asserting a claim to the IP. These types of controversies can negatively impact the company's ability to close a critical sale or financing transaction – and the company and investors should work with their counsel to identify ways to obtain a prompt resolution of these issues.

- Lenders and investors should consider which parties possess security interests in the IP. The range of options available to the company and investors in any restructuring will be largely driven by whether there is a lender with a valid and perfected security interest in the IP. A foreclosure on the IP by a senior secured lender would wipe out any junior interests in the IP – but foreclosure proceedings can needlessly destroy value and lenders are frequently inclined to work with the borrower and other stakeholders where there is a realistic possibility of a successful turnaround.

- Retaining talent in startups is critical. Employees often begin to search for other opportunities upon hearing that the company is in financial distress – and this problem is particularly acute in the startup space where talented employees likely have many other options. The risk of losing crucial employees underlines the need for the company to develop and quickly execute a comprehensive restructuring game plan that minimizes workforce disruption. The company should also work with its advisors to explore what types of incentives are available to encourage employees to stay with the startup through the proceeding.

- Investors in startups often wear multiple hats. It is common for the same person to be an equity holder, secured lender, executive, and director all at once. There are plainly good business reasons for this type of arrangement when a startup is getting off the ground, but the varying roles can create potential conflicts and personal liability for an investor in a distressed business. By way of example, a

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secured lender's best option following a default by the borrower, may be to realize on its collateral through a quick and efficient out-of-court foreclosure. However, enforcement actions by a secured lender may create conflict and fiduciary duty issues if the lender is also an equity holder and sits on the company's board of directors. Investors need to be mindful of these types of issues and proceed with caution – missteps can easily make a bad situation worse.

- Investors should carefully review the documents governing their investments in the startup and payments received from the company. In a bankruptcy case, under certain circumstances, the courts may "recharacterize" debt instruments as equity interests based on the document's characteristics, resulting in a subordination of the investor's claim below other creditors, with potentially disastrous implications for any possible recovery. And – while somewhat rare in the startup space – investors should be aware of the potential for "clawback" lawsuits arising from payments made to investors from the company. Investors and their advisors should seek opportunities to address documentation problems in advance of the restructuring.

- The company's management and investors should also ensure that the company is properly withholding and disbursing taxes to the appropriate governmental authorities. In certain circumstances, taxing authorities can hold those in control of the company personally liable. Directors and officers can also potentially be liable to employees for wages if any layoffs are not conducted in accordance of applicable state and federal WARN Acts.

- Investors and their advisors will have to consider the issues outlined in this article, as well as many others, in determining the best course of action for a troubled startup. For some businesses a sale or distressed financing may be possible; for others a chapter 11 case or consensual foreclosure may present the best opportunity to preserve value and maximize recoveries on investments. In any case, experienced counsel will be indispensable in guiding the startup and investors through the process.

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