

# Bankruptcy

## Many high rollers left high and dry

**Service providers and equity holders may find themselves at the bottom of the 'food chain' as dot-coms go bankruptcy route.**

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DURING the past three years, the dot-com phenomenon caused many to "jump in the Internet game." As a result, numerous business relationships on various levels developed between "new economy" companies and traditional, service-oriented, brick-and-mortar companies. In some cases, service providers, such as consultants and accountants, offered significant discounts to dot-com startups in exchange for stock or stock options. Others swapped equity financing for long-term service contracts and an opportunity to announce to Wall Street the formation of a new "strategic alliance."

Unfortunately, what looks like a good idea in a sizzling market has a converse effect when the bear emerges from hibernation. Recently, many new economy investors not only lost significant equity value, but also performed substantial services for Internet companies and were left with nothing to show for it except bad debt, worthless receivables and a potential

lawsuit by a bankruptcy trustee to recover preferential payments (if they were lucky enough to receive any accounts receivable payments).

By the end of the year, many of these new economy companies will rewrite their business plans, restructure their business models, liquidate and/or file for bankruptcy protection. Service providers that extended equity financing and entered into long-term service contracts will bleed the most from these developments.

**Service providers that extended equity financing and long-term service contracts will bleed the most by year end.**

Most, if not all, start-up Internet companies relied on external sources for both their financial and infrastructure growth. This provided a two-fold opportunity for service providers to strike it rich. To take advantage of the equity upside, several service providers invested millions of dollars in unprofitable companies for a piece of the "pipe dream." In hindsight, they ignored the basic premise that the true value of a business is measured by its actual profits and realizable assets. These onetime savvy investors further ignored the mounting debt and judged these "high-flying" Internet companies on anticipated long-term growth and potential earnings.

The service providers, however, had a built-in safety net that would allow

them to pay down their investment and take advantage of the start-up's need for services. Hence, the traditional exclusive provider contract was rewritten. For example, Company A would invest \$2 million in Company B. In return, Company B would enter into a long-term service agreement with Company A, with annual progress payments of approximately \$2 million. By the end of the first year, the service provider would have received revenues equal to its principal investment and would have benefited from the dot-com's stock appreciation. In addition, this cozy relationship allowed the service provider to fatten its bottom line by creating receivables and by expanding its work force and market share.

In theory, both parties benefited from this arrangement. After all, there was plenty of cash to burn and venture capitalists to pitch for additional funding.

In a bankruptcy scenario, however, service providers with equity investments and long-term contracts have three strikes against them. Strike one is best characterized as a fastball right down the center of the plate. Sec. 507 of the Bankruptcy Code establishes a priority scheme for paying creditors and equity holders of the debtor. Under this scheme, pure equity holders of a debtor are entitled to be paid dead last: For them to be paid anything in a bankruptcy case, there must be enough assets to pay in full all other creditors of the debtor. In theory, the glass may be perceived as half full, but in reality, an

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equity stake in a failed dot-com provider is essentially worthless. Strike one!

### **Batter up**

Furthermore, it is unlikely that the new economy company has been in business for any length of time and actually paid for all of the services that were rendered by the service provider during its short lifespan. Therefore, the service provider is also a creditor of the new economy company. According to the priority scheme described above, unsecured claims share in the assets of the estate before equity holders. Unfortunately, in most dot-com cases, few assets remain upon liquidation. Assuming that any assets are available for distribution to general unsecured creditors, the service provider may be equitably subordinated to other creditors. Under § 510(c) of the Bankruptcy Code, claims of creditors that hold stock in a company may be subordinated to the claims of nonequity claimants if their unsecured claim is disguised as an equity interest or is fraudulent as to other creditors. Strike two!

However, this painful inning is far from over. While the service providers were performing what turned out to be charity work for start-up companies, they were also expending valuable resources and drawing on their own credit facilities to pay for these services. Eventually, the service providers' cash flow will dry up, leaving the provider in a crisis itself. Swing and a foul ball.

To add insult to injury, if a dot-com bankruptcy case is filed, a service provider creditor may be sued by a trustee for all accounts-receivable payments made by the new economy company within 90 days of the bank-

ruptcy petition date.<sup>1</sup> In the case of an "insider," the preference period is extended for a year. In theory, the purpose of a preference action under § 547(b) of the Bankruptcy Code is to promote equality of distribution among similarly situated creditors. In reality, most clients are flabbergasted by the fact that they performed services or provided a product, were actually paid, and now have to return the money to the estate in exchange for a worthless claim or pennies on the dollar.

Of course, there are exceptions to every rule, and in this case, § 547(c) of the Bankruptcy Code provides the disgruntled service provider with some relief. It lists six circumstances under which otherwise avoidable transfers become immune to the trustee's avoiding powers. However, in the case of the greedy service provider with an equity interest in the debtor and a long-term service contract, the crux of the analysis tends to shift to whether the service provider was an insider of the new economy company and therefore, whether the reach-back period should be extended to a year. Strike three may be the final out.

### **The inside scoop**

In general, an insider is a person or entity that has either actual control or the ability to control or influence the actions of the debtor. In a corporate setting, insiders include directors, officers or any person in control of the debtor. An affiliate of the debtor is also considered an insider.<sup>2</sup> Sec. 101(2) defines an affiliate of the debtor as an entity that holds the power to vote 20% or more of the debtor's securities, regardless of whether that entity uses the

interest to exercise control. On the other hand, if an entity holds less than 20% of the shares, then by definition that person must exercise a certain level of control or influence over the debtor to be deemed an insider.

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### **The crux of the analysis will shift to whether the service provider was an insider of the new economy business.**

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Often, service providers have less than a 20% stake in the new economy company and are able to avoid the strict application of the definition. They can be confronted with the control issue, however, which is a question of fact. Substantial investors often insist on having their own representatives on the board of directors of the company. Furthermore, some investors provide new economy companies with financial and business advice, services, space, furniture and equipment. These facts inch the service provider ever closer to being considered an insider under the Code.<sup>3</sup>

Over the past three years, several service providers were invited to play ball with dot-com companies and join in the "gold rush." Unfortunately, some players are leaving the ballpark empty-handed, while others will be forced to return and play a doubleheader with the trustee. In the end, the bankruptcy experts will be called upon to rectify the tech-wreck.

(1) 11 U.S.C. 547.

(2) 22 U.S.C. 1010 (31) (B) and (E).

(3) See *In re Chas. P. Young Co.*, 145 B.R. 131 (Bankr. S.D.N.Y. 1992). But see also *In re David Jones Builder Inc.*, 129 B.R. 682 (Bankr. S.D. Fla. 1991).