March 25, 2014 Module 3 – Harvesting Investments

I. Background

A. Financing History of XYZ Corp. - XYZ Corp has raised three rounds of venture financing as follows: $10M Series A round; $10M Series B round; and $20M Series C round. Each round is participating preferred and Series C is senior to Series B which is senior to Series A. In addition, one year ago, the company borrowed $5M from a venture lender and secured the loan with all the IP of the company. The current balance of the venture debt is $4.5M.

B. Board of Directors – XYX Corp. has a five person board consisting of: the CEO; an independent director who is chairman; one director representing the Series A investors who invested $4M in Series A and $2M in Series B then cut back significantly in Series C; one director representing the Series B who invested $2M in the A round, $4M in the Series B and $4M in the Series C; and one director who invested $10M in the Series C round and did not invest prior to that. Each series of preferred stock has separate class voting rights. None of the investors believe putting more money into the company makes sense and the Series A investor is a partner in a firm that is almost out of money.

C. Exit Scenario - The board of XYX Corp. has determined that the performance of XYZ Corp. does not merit further financing and has decided to put the company up for sale. The business has deteriorated to the point that none of the directors expect to sell the company for more than the aggregate $45M in liquidation preferences and venture debt, although they are unsure as to what value could be obtained in the sale. In light of this, the CEO has demanded a management carve out plan be put in place for the sale process and has interviewed boutique investment bankers to run the sale process.

II. Issues

A. Assuming a sale of the company for more than $5M but less than $45M, how should the liquidation preferences, carve out (if any) and venture debt be handled?

B. What is an appropriate carve out structure for management, if any?

C. Should an investment bank be retained and if so, how will they be compensated?

D. What are the fiduciary duties of the CEO, independent director and venture capital directors on the board in this situation? Do they have different roles to play?

E. How will the three venture directors act in representing their respective classes of preferred stock?

F. If the company runs out of money before a sale is completed, how will it be funded to the sale?

G. What are the "statutory obligations" of the directors and the company to its employees, lender, vendors, taxing agencies, etc.?