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The Risks of Insolvency in Venture Capital

By Alan Parker, LLM Candidate 2016 | April 22, 2016

The venture capital industry has one goal: making startups incredibly lucrative and, thus, maximizing returns to venture capital investors. For the venture capital investor these outstanding returns are generally materialized 5 or 6 years after the Series A investment round, when the investor makes an exit and the startup either performs an initial public offering of its shares (IPO) or is sold to a strategic acquirer or a private equity fund.

However, in a business inherently risky as venture capital, there are also many examples of failures, where venture capital backed startups go insolvent or bankrupt. This happened recently with online retailor and Montreal-based Beyond the Rack, which had previously raised over U$90 million in venture capital investments and other financings. When the company was entering into insolvency, it pursued a sale with a potential buyer, but negotiations fell through, forcing it to file for creditor protection on March 23.

Although this company became insolvent and later filed for creditor protection under Canadian laws, where it is based, the story is not strange to the Silicon Valley industry. It is important to emphasize that the U.S. does not have a specific federal statute to be applied when a company is simply insolvent, as opposed to what happens when it formally files for creditor protection or bankruptcy. Corporate insolvency means that a company is in financial distress and with difficulties to raise new capital through issuance of equity or debt. Notwithstanding the lack of a federal statute regulating the insolvency period, there is robust case law providing that in such circumstances the members of the Board of Directors of the insolvent company also owe fiduciary duties to the creditors of the company, and not only to its shareholders.

As mentioned in previous articles, essentially all venture capital firms will have a seat on the Board of Directors of the portfolio companies, and when the venture backed startup approaches insolvency or is insolvent, several conflicts of interest may arise. On one side, the member of the Board appointed by the venture capital firm will likely pursue a strategy more favorable to the investor (shareholder), and on the other side the same Board member will have a legal fiduciary duty towards outside creditors of the company. This situation can expose venture capital firms and the respective Board members to significant liabilities.

In order to be protected from said liabilities, there are a number of alternatives that may be applicable in countless scenarios, but in general the directors may have to adopt difficult strategies that adversely impact the chances of the shareholders recovering its investments, while maintaining assets to the benefit of creditors. Other protective measures for the VC Board members include having strong D&O insurance policies and being very thorough with formalities, such as with the minutes of the meetings of the Board of Directors.

On a related matter, it is worth pointing out that, for the first time, a Court[1] held that private

[1] *Sun Capital Partners III, LP v. New Eng. Teamsters & Trucking Indus. Pension Fund, 2016 BL 95418, D. Mass., No. 1:10-cv- 10921-DPW, 3/28/16*

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equity funds individually owing less than 80% of the invested company were liable for the pension obligations of the latter. This precedent confirms that investors and its Board members, regardless of their nature, should increase their scrutiny in structuring investments and dealing with conflicts of interests, especially when the portfolio company is in financial distress.