Dot-Coms Start To Face The Prospect Of Bankruptcy

by Jeffrey A. Wurst
Chairman, Financial Services and Bankruptcy

June 1, 2001

In recent weeks there has been growing attention upon dot-coms running out of working capital. Attention has initially focused on Peapod Inc., drkoop.com Inc and CDNow.Inc. Each of these companies has recently issued its annual report with a "going concern" limitation. In other words, their independent auditors questioned the ability of each company to continue as a "going concern."

Henry Blodgot, the Merrill Lynch analyst, recently announced his prediction that two-thirds of today's dot-coms will fail. Internet analyst, Joe Sawyer of Forrester Research, Inc., has predicted that most of the on-line retailers will be out of business by the end of this year.

We continue in the greatest bull market in history. Initial public offerings (IPOs) for dot-coms often found their stock trading at multiples of the offering price by the closing bell of the issue date. Can these prices be sustained? Will the present freeze on dot-com IPOs result in those companies being left out in the cold? This is not to say that "what goes up must come down." It should be recognized, however, that everyone would not survive. For example, Beyond.com and CyberShop have recently closed and Boo.com has laid off many of its workers.

Crain's New York Business recently devoted two front-page articles to the increasing concerns over the likelihood that dot-coms will not survive. New York ad agencies are exercising caution in the dot-com exposure. Landlords are taking tougher positions in lease negotiations with dot-coms. Many are now recognizing the risks of investing so heavily in start-ups -- even start-ups with such great ideas?

At a recent meeting of the New York Capital Roundtable, Ben Boissevain, a managing director of Agile Equity and an investment banker dealing exclusively in dot-coms, predicted that there would only be two or three survivors in each market sector. He warned, "Do not be the last company in your sector to be sold." In the early 1990s Bossevain was active in buying and selling Russian companies and compared that experience with dot-coms. Early on, Russian companies sold at high premiums – everyone wanted one – nobody had one. His last sale of a Russian company was for one ruble. He predicts this kind of result with dot-coms.

What then, does a dot-com do? Sell now for maximum value? Assume the risk of being the last one to sell? Or, be prepared to buy out all survivors in its sector?

What will happen to dot-coms that run out of capital?
They will either find additional venture capital (with or without a merger), they will reorganize (with or without the protection of the Bankruptcy Court) or they will liquidate (also, with or without a bankruptcy filing).

The likelihood of additional venture capital is slim unless the venture capitalist (VC) is a buyer who is prepared to keep buying until he owns the sector. The difference between this VC and the start-up VC is that this VC must see to it that more traditional accounting and business practices are in place. This VC is likely to be more active in management, if not controlling. This VC will use more traditional business models to measure performance.

What assets does a dot-com have?
Some dot-coms, such as Peapod and Amazon, have started their transition to a "click and mortar." Peapod, for example, maintains distribution centers in Chicago and San Francisco while serving in other markets through exclusive arrangements with traditional grocery retailers. Other dot-coms continue to rely on fulfillment centers, thus avoiding the kinds of assets upon which traditional lenders and bankruptcy courts rely. Dot-coms, however, tend to have their value in *soft assets* – assets whose values have traditionally been considered as negligible, if at all, at least from the point of view of traditional lenders and bankruptcy courts.

What kind of value exists in soft assets?
These assets fall into a number of categories:), intangibles, wetware (a

Silicon Valley term for ideas, management and personnel) and financial performances. Start-up dot-coms have been able to affect their raise-ups relying primarily on "ideas." Survival (or the ability to reorganize) will be dependent on management --making the company perform more efficiently -- and personnel -- an important asset in a full employment marketplace. Finding software developers has become so difficult that companies may soon look to buy other companies primarily to obtain their work force.

Tax planning discourages placing significant value on intangibles. Yet, there are significant assets to a dot-com – software, patents, trademarks, trade names, copyrights, URLs, customer lists, goodwill, etc. What, for example, is the value of the name *Amazon.com*? These are assets that have been intentionally passed over in assessing value. Long term depreciation or not – these are the assets at the core of a dot-com and they have value – sometimes significant value.

In valuing a dot-com, buyers (whether in or out of the bankruptcy court) will now be looking at financial performance as well. What are the projections? What is the revenue? When will the company become self-sustaining and turn a profit? The closer to that date, the more likely it is that a better price will be paid. In the event of a bankruptcy, these issues will be critical in determining whether a proposed reorganization will be feasible.

What role will the bankruptcy courts play in dealing with failing dot-coms? To a great extent this depends on how significant the creditor body is. Are there any secured creditors? There are some traditional lenders who have *ventured* into dot-coms. We have also recently seen "junk bonds" enter the internet-financial arena with financing for companies such as 1-800-Flowers.com, Tunes.com and Mortgage.com.) What unsecured creditors exist? Service providers, vendors, fulfillment centers, landlords, etc. Each of these traditional and non-traditional creditors will look to the bankruptcy court to see to it that it receives a "fair" treatment.

What are the advantages and disadvantages of a bankruptcy?
The most significant disadvantages of reorganization in bankruptcy are the stigma associated with it. Less so, but still a risk, is the potential for loss of control.

The advantages include protection from creditors, an opportunity to reduce debt and the protection of the bankruptcy court allowing a reasonable *time out* while restructuring debt in a protected environment or a sale with competitive bidding to ensure obtaining the highest price for a sale of the assets (either piecemeal or as a going concern). Buyers of distressed companies enjoy the protection afforded by the bankruptcy court order that the buyer has purchased assets free and clear of all liens and claims. Certainly, if the dot-com were to be sold, it would be better to sell before a bankruptcy becomes necessary. But even so, many buyers will prefer the insurance provided by the bankruptcy order.

Too often parties wait too long to seek the protection of the bankruptcy court, leaving no value to induce an interested buyer. Thus, principals of dot-coms must promptly evaluate their positions and determine whether they will be sellers or "stayers". The so-called "vulture funds" and other investors in turnaround situations are standing by ready to seize the moment. Timing will determine the price.

Whether you are a buyer or a seller it is important to carefully consider the value of the assets and the venue for the sale or acquisition – in or out of bankruptcy. Waiting too long may result in a sale for the proverbial *one ruble*.

Jeffrey A. Wurst *is partner and chair of the Financial Services, Banking & Bankruptcy Department at Ruskin Moscou Faltischek, P.C.. He can be reached at 516-663-6535 or* ***jwurst@rmfpc.com****.*