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Winding up a startup? Steps and precautions entrepreneurs should take to avoid trouble

By *J Vignesh*, *Mugdha Variyar* & *Shashwati Shankar*, ET Bureau | Updated: Mar 17, 2017, 10.55 AM IST

Aseem Khare, the former chief executive of the now defunct home-services startup Taskbob, knew at the beginning of December that he had to make the hard call. He had to shutter Taskbob's operations. Khare and his core team went about doing what they felt was right for all the stakeholders.

At the end of the gruelling process of shutting down operations, he shared with customers a list of all of Taskbob's verified service professionals—electricians, plumbers, carpenters, appliance repairmen, house cleaners, car cleaners, drivers—so as to keep the 'Taskbob spirit alive.'

Closing down a company is a hard call for any entrepreneur to make. Not many get to close without creating any bad blood. The recent homestay aggregator Stayzilla incident is a sore example. Stayzilla founder Yogendra Vasupal was arrested on Tuesday following a police complaint by an advertising vendor over alleged non-payments.

When an entrepreneur decides to shut shop, vendor dues are one of the key things to take care of. There are other stakeholders in the fray: investors, employees and customers. Srikanth Sundararajan, independent investor and former venture partner at Helion Advisors, explained what the right process should be: "Inform all shareholders and get their approval. The shareholders can be investors, founders, key employees and financial institutions like venture debt or traditional banks, who may have provided debt. Then ensure all liabilities like PPF, employee dues and financial debt are cleared, and then inform and handle other creditors like vendors."

While it might seem like a tedious process, proper planning and execution might make it less bitter. The plan should include termination of services and contracts, vacating the office and returning dues to all stakeholders. "Not being haphazard is important. In our case, most of the team had left and just two or three of us had to shut down everything on our own," said Abhinav Agarwal, cofounder of on-demand laundry startup DoorMint, which closed down in September. "The key is to have strong communication and be very frank both ways; your team should be able to trust you. No twisting of facts but accepting reality."

Breaking the news to the employees is a challenging task but being honest was Khare's way of doing it. "Things were on a downward spiral one or one-and-a-half months before (closing operations). When we were clear that we had to shut down, the first priority was our employees; their lives should be sorted first. We asked our employees to start looking out. I had to get them out-placed and give them a severance package," said Khare.

For Pardeep Goyal, cofounder of edtech startup SchoolGennie that shut in 2014, the priority was to help his customers—schools using its software—to transition to other vendors during the process. The company returned the money it owed to the 10 schools it had signed up for a year.

"Schools had given us cheques for the entire year, so we returned the money when we decided to pull the plug within a few months. We also made sure we communicated with them early on. The school managements were not entirely happy with the change but at least there were no payment issues and we helped them transition to other similar database software," he said. Leaving in good faith helps in ensuring you can go back to your customers when you launch a new business.

"There is a hierarchy of stakeholders of a startup who should be given their dues on priority basis when the company is winding up," said Sharad Sharma, cofounder of software products thinktank iSPIRT. "The employees need to be paid first... After employees come vendors, debtors, equity holders and then the management."

Also, any disputes with vendors or other stakeholders need to be resolved before a company shuts. Corporate lawyer Vaibhav Parikh, partner at Nishith Desai Associates, said that any intentional non-payment to a vendor should be backed by a contract and be communicated in advance.

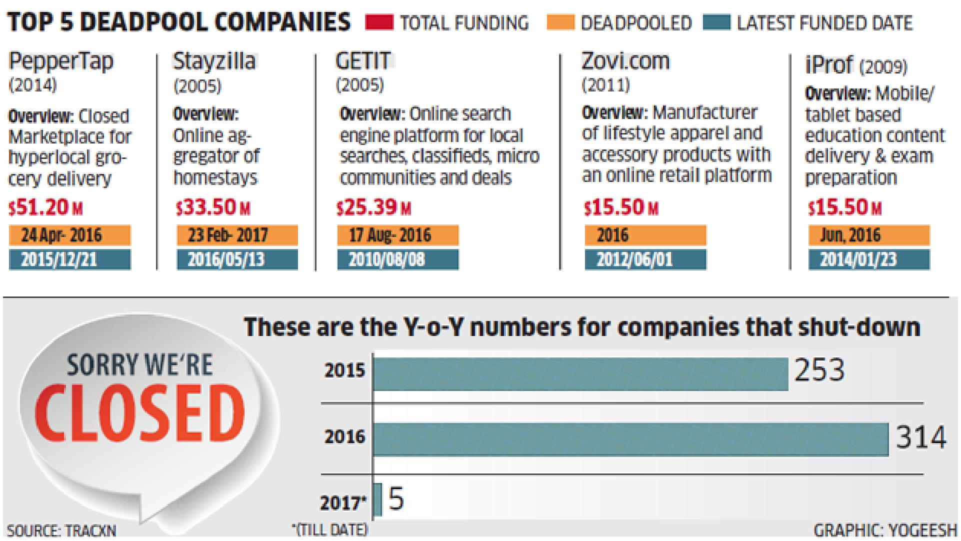
"If a company has taken services from a vendor, they should generally pay. In case they find the services unsatisfactory, they can hold payments provided they have clearly mentioned in the contract that payments will be based on satisfaction. If services are deficient, they should inform the vendor early on at the time of the service that the service has not been completely delivered, and not at the time of the payment," Parikh said.

Startups shutting shop and unable to make payments due to a cash crunch have legal options to ensure they do not land up in trouble. An Indian company that wants to shut down can file an application for corporate insolvency resolution with the National Company Law Tribunal. Once the process is initiated, the NCLT can declare a moratorium on legal proceedings for recovery of debt. If attempts at reviving the company fail, the liquidator will decide how the assets of the company should be distributed to the creditors, according to Parikh.

While shutting down a startup is still a stigma in India, the process is smoother in the United States. "Silicon Valley is well-known for its 'fail fast' mantra—i.e. try out a new idea and if it doesn't stick, move on quickly to the next big thing," said Sanat Rao, partner at IDG Ventures. "In the US, startup failures are considered a part and parcel of entrepreneurship and not a gloomy scenario as it is in India. The startup, investment community and the media in the Valley all understand that in order to succeed, you have to fail many times."

Company boards, too, have an important role. The directors on the boards need to ensure that entrepreneurs understand their liabilities. Board should sensitise founders to what risks and liabilities are involved when shutting down or during a cash crunch, said Mukul Singhal, partner at Pravega Ventures. "The board should discuss well in advance the different scenarios in the long run, including the possibility of shutting down the company. If (tax deducted at source) is not paid, even the investors could go to jail."

Eventually, all of this comes down to leadership in a crisis. "How leadership plays a role when it comes to layoffs or shutdowns is very important. Is your leader visible? Therein comes your basic elements of equality and 'being human' factor. The employee should feel I went through this, but I was treated with respect," said Francis Padamadan, Country Director at recruitment firm KellyOCG India.



WINDING UP—WHAT ARE YOUR OPTIONS

Strike it off
A company can apply to the Registrar of Companies for removing its name if it has not commenced its business within a year of incorporation, or if it has not done any business or operation for two financial years. The startup should not have applied for obtaining the status of a dormant company.

PROS: The process is well defined and meant to be done with quickly and at a cost lower than the regular winding up routine for companies.

CONS: The main challenge for a company lies in meeting the requirements to qualify for striking off its name from the RoC's register. The discretion on this is vested with the RoC. Also, even after a startup is removed from the register, its senior executives, managers and directors will continue to bear certain liabilities that can be enforced as if the company had not been dissolved.

WINDING UP—TWO ROUTES

Voluntary Winding up
Certain provisions of the Insolvency and Bankruptcy Code, 2016 are yet to be notified and, therefore, the Companies Act, 1956 continues

to apply in the case of a voluntary winding-up of a company by its shareholders. The company should file a petition for voluntary winding up before a high court after getting shareholders with voting rights to approve a special resolution on this.

PROS: If the shareholders are on the same page and the company has no debt, the voluntary winding up option allows for a relatively simpler and internal process of shutting shop.

CONS: This process can be long-drawn given the involvement of official liquidators and the court or the National Company Law Tribunal.

Through a Tribunal
The National Company Law Tribunal has the powers to decide if a company should be dissolved. This is a discretionary and 'last resort' remedy. Courts are typically reluctant to order the winding up of a company on just and equitable grounds if an alternative remedy is available.

PROS: This option provides a window in situations where the creditors do not support the winding up of a company but its shareholders want it to shut down

CONS: The tribunal/high court route is usually long-drawn and may involve unpredictable legal expense.

SHUTTING DOWN THE RIGHT WAY— WHAT FOUNDERS SHOULD DO

With Employees
Communicate right: Do not paint a rosy picture of a business that's struggling. Being honest will help gain goodwill, if not anything else.

Seek out placements: Get an external recruitment agency or use your own sources to help your employees find new jobs. Do not leave behind disgruntled employees or things could turn ugly.

Offer severance packages: At the very minimum, offer your employees a runway for the next one or two months so they can manage their household financials for a while.

Accept responsibility: The true worth of a leader is when he or she stands up when things are not going right. Delegating to the human resources department the dirty job of handing layoff notices is not the way to go about it.

With Customers
Explain with gratitude: Email customers explaining the situation and thank them for their custom. Ensure that your mail has a 'heart' and is not a curt 'we are closing' communication. If possible, provide a list of other service providers. And if a customer calls even after the business is shut, do try to help them. This will earn you goodwill and possibly a ready customer for your next venture. Also, return payments to customers for services not completed.

With Vendors
Don't burn till the end: Do not sign up vendors for new services if you are running out of money. Plan with stakeholders and vendors well-ahead, be transparent and keep the communication channels open for vendors and partners.

Demonstrate intention to repay: If you have no option but to delay payments communicate that in advance to your vendors. It is important for startups to reflect the real status of the business and not paint a rosy picture when facing a crisis. Because that would amount to misinforming vendors who might be considering a proposal to work or partner with the company. If a vendor files a police complaint over nonpayment, founders can pull out their communications and contracts to show there was not intent to defraud.

INVESTORS AND DIRECTORS:

Duties And Responsibilities
Investors and directors on the boards of startups have to guide entrepreneurs on their various liabilities, including on the need to keep aside cash for potential regulatory and contractual requirements. The board should, well in advance, discuss with entrepreneurs how the company can be prepared to handle different business scenarios, including the possibility of pulling down the shutters.

Investors should routinely update themselves on the financials of their portfolio companies to understand the state of the businesses.

(Source: Abhilekh Verma, Partner at law firm Khaitan And Co)