

**IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE**

In re:

Baxano Surgical, Inc.,¹

Debtor.

Chapter 11

Case No. 14-12545 (CSS)

**DECLARATION OF JOHN L. PALMER IN SUPPORT OF
CHAPTER 11 PETITION AND RELATED MOTIONS**

Pursuant to 28 U.S.C. § 1746, John L. Palmer declares as follows:

1. I am at least 21 years of age and am competent to give this declaration. I have knowledge of the matters to which I hereinafter attest, except where otherwise stated. I have also reviewed the relevant documents of the above-captioned debtor and debtor-in-possession (the “Debtor”) and have spoken with certain directors, officers and/or employees of the Debtor and certain professionals employed by the Debtor, as necessary, and where I have relied upon such information do believe such information to be true.

2. I the President of Tamarack Associates, Inc. and have been engaged as Chief Restructuring Officer of the Debtor. I am authorized to submit this declaration (the “Palmer Declaration”) on behalf of the Debtor.

3. On November 12, 2014 (the “Petition Date”), the Debtor filed a voluntary petition in the United States Bankruptcy Court for the District of Delaware (the “Court”). The Debtor will continue to operate its business and manage its properties as a debtor-in-possession.

4. I submit this First Day Declaration on behalf of the Debtor in support of (i) the Debtor’s voluntary petition under chapter 11 of title 11 of the United States Code, (as amended,

¹ The last four digits of the Debtor’s tax identification number are 9022. The address of the Debtor’s corporate headquarters is 110 Horizon Drive, Suite 230, Raleigh, North Carolina 27615.

the “Bankruptcy Code”), and (ii) the Debtor’s “first-day” motions (collectively, the “First Day Motions”). The Debtor seeks the relief set forth in the First Day Motions with the goal of allowing the Debtor to continue to operate post-petition and minimizing the adverse effects of the commencement of this chapter 11 case (the “Chapter 11 Case”) on its business. I have reviewed the Debtor’s petition and the First Day Motions, or have otherwise had their contents explained to me, and it is my belief that the relief sought therein is essential to ensure the continued survival of the Debtor and the success of this Chapter 11 Case.

5. The board of directors of the Debtor has authorized the filing of this Chapter 11 Case.

6. The bankruptcy filing was compelled by exigent circumstances and the need to take immediate action to preserve the Debtor’s going concern value.

7. As discussed below, the Debtor has been pursuing opportunities to sell its assets in a manner that maximizes value for its stakeholders since September of this year. Approximately, three weeks ago, the Debtor reached agreement on a non-binding termsheet to sell all but one of its product lines to a well-funded strategic purchaser who was to serve as a stalking horse in a to be filed bankruptcy proceeding. The price indicated by the presumed stalking horse would have been sufficient to repay the Debtor’s obligations to its pre-petition secured lender in full. On the strength of the termsheet, the Debtor was able to obtain a tentative agreement from its secured lender to provide debtor-in-possession funding that would have carried the Debtor through a normal bankruptcy sale process. However, last Friday afternoon, the presumed stalking horse advised the Debtor that it was no longer willing to serve as a stalking horse. Upon receiving that advice, the Debtor and its secured creditor were forced to re-group and consider next steps. It was not until November 11, 2014, that a tentative commitment was obtained from the Debtor’s

secured creditor to provide a smaller amount of debtor-in-possession financing to fund a greatly accelerated sale process, this time without a stalking horse.

8. Accordingly, given those exigencies, the Debtor filed its bankruptcy petition on November 12, 2014 with the intention of seeking limited first day relief in the form of motions: (a) authorizing the payment of pre-petition wages and related relief; and (b) authorizing interim debtor in possession financing and use of cash collateral. After the first day hearings on those Motions, the Debtor intends to file additional “first day” operational motions in the immediate future. I intend to submit a supplemental Declaration in support of those additional motions.

I. INTRODUCTION

9. The Debtor is a Delaware corporation headquartered in Raleigh, North Carolina.

10. The Debtor develops, manufactures and markets minimally invasive medical products designed to treat degenerative conditions of the spine affecting the lumbar region. As of March 31, 2013, over 13,500 fusion procedures and 7,000 decompression procedures have been performed globally using the Debtor’s products.

11. The Debtor sells its products through a combination of independent distributors and a contract sales staff supported by a staff of regional sales managers, which are all Debtor employees. Approximately 50% of monthly sales are effected through distributors. The Debtor believes that maintaining this distribution channel is critically important to its survival during the course of this proceeding.

12. The Debtor has experienced losses since its inception. Losses from operations have resulted principally from sales and marketing costs that have historically exceeded gross profit, costs incurred in research and development programs and from general and administrative expenses, including significant costs associated with establishing and maintaining intellectual

property rights. Those operating losses are projected to continue into the foreseeable future in spite of massive reductions in the sales and marketing staff from 46 full time employees at the beginning of the third quarter to six as of the petition date.

13. The Debtor elected to close its San Jose manufacturing facility as of the end of November 2014 in order to reduce costs. The Debtor planned to transfer manufacturing to Ventra, a contract manufacturing company located near the Debtor's San Jose facility. The transfer of manufacturing is stalled due to the inability to get critical components from vendors owed significant sums. The continued survival of the Debtor as an on-going concern is critically dependent upon successfully transferring manufacturing and opening the component pipeline. The Debtor lacked sufficient funds to conduct these activities in the absence of the current petition.

14. As a result of the foregoing, approximately three (3) months ago the Debtor concluded that it was not a viable stand-alone business. As a result, on September 9, 2014, the Debtor employed Houlihan Lokey Capital, Inc. ("Houlihan") to assist in, among other things, its search for a buyer or buyers. While those efforts have not yet produced a buyer or buyers for the Debtors business, the Debtor will seek court approval to retain Houlihan and anticipates seeking court approval to engage in a sale process in these bankruptcy proceedings.

15. By seeking bankruptcy protection, the Debtor is afforded the opportunity to maintain its operations and provided the necessary time to complete the anticipated sales process for the benefit of stakeholders. Absent the bankruptcy filing, the Debtor will run out of cash, shut down its operations, and liquidate, all to the detriment of its employees, customers, suppliers, and creditors.

16. In order to finance the continued operations of the Debtor during the completion of the marketing process, the Debtor's prepetition lender, Hercules Technology Growth Capital, Inc. ("Hercules" or the "Prepetition Lender"), Debtor has agreed to: (i) consent to the continued use of cash collateral; and (ii) provide the Debtor with debtor-in-possession funding (the "DIP Financing") up to \$350,000, in each case pursuant to the terms of the DIP Credit Termsheet (as defined below) and orders approving the use of cash collateral and the DIP Financing acceptable to Hercules. If the DIP Credit Termsheet is approved by the Court, the Debtor will be able to draw up to \$250,000 immediately upon issuance of an interim order approving the DIP Credit Termsheet provided, however, the final \$150,000 of the said \$250,000 may be withheld by Hercules in its sole discretion. I believe the Debtor would be forced to immediately cease operations and liquidate its assets absent the funding contemplated by the DIP Credit Termsheet.

II. BACKGROUND OF THE DEBTOR

A. Business Operations

17. The Debtor was founded as a Delaware corporation in 2000 under the name "XiaMed, Inc." and later changed its name to "TranS1 Inc." in February 2003. The Debtor changed its name from TranS1 Inc. to Baxano Surgical, Inc. following a merger between Baxano, Inc. and TranS1, Inc.

18. The Debtor's common stock is traded on the NASDAQ exchange under the symbol BAXS.

19. The Debtor participates in the minimally invasive spine segment which has been the fastest growing area of the spine business for the past five years. The Debtor markets a number of products, including the AxiaLIF pre-sacral access and interbody fusion system, the VEO lateral access and interbody fusion system and the iO-Flex series of flexible instruments. During the first nine months of 2014, sales of iO-Flex were approximately \$7.2 million,

representing approximately 55% of the Debtor's total sales for the period, sales of AxiaLIF were approximately \$3.6 million, representing approximately 28% of the Debtor's total sales for the period, and sales of VEO were \$1.6 million, representing 12% of total period sales.

20. AxiaLIF has been manufactured by third party OEM manufacturers since its introduction. iO-Flex was traditionally assembled in the Debtor's facility in San Jose from over 200 components supplied by third party manufacturers. The majority of these components are custom manufactured to the Debtor's specifications, frequently using tooling owned by the Debtor, located at outside vendors. The Debtor is currently in the process of establishing Venta Medical Products, Inc. as the OEM manufacturer of the final assemblies of iO-Flex. As noted previously, the Debtor determined that it would not be able to complete the transfer of manufacturing and restart the supply pipeline absent a bankruptcy filing.

21. The Debtor leases approximately 12,750 square feet for its principal executive officers in Raleigh, North Carolina and an additional 1,700 square feet in the same building for its commercial operations. The Debtor also utilizes a 4,375 square foot training center in an adjacent building. Additional property in Wilmington, North Carolina is used for warehousing, office space and research and development. The Debtor has vacated its leased space in Wilmington and will shortly be petitioning the court to reject this lease. The Debtor intends to vacate the training facility by the end of November 2014 and reduce this lease.

22. Since inception, the Debtor has not been profitable. As of the end of August, 2014, the Debtor had an accumulated deficit of approximately \$189 million, current assets of approximately \$10.8 million, secured debt of \$7.5 million and other debt totaling approximately \$20 million. In 2013, the Debtor suffered a loss of approximately \$32.03 million on revenues of approximately \$18.58 million.

B. Corporate Structure And Capitalization

23. The Debtor has funded operations with proceeds from the sale of securities traded on the NASDAQ Global Market. The Debtor has approximately 58 million outstanding common shares. Approximately 22% are held investment funds owned or associated with current Board members as well as management. Another 18% is held by investment funds associated with former Board members that are no longer considered insiders. The remaining 60% of the outstanding common shares is held by mutual funds, institutional funds, and individual shareholders through brokerage firms.

24. On December 3, 2013, the Debtor obtained a secured credit facility from the Prepetition Lender of up to \$15,000,000 to retire an existing credit facility and for general working capital purposes. The Prepetition Credit Facility was secured by first priority liens (the “Prepetition Security Interest”) on substantially all the Debtor’s property (the “Prepetition Collateral”) pursuant to the terms of a loan agreement (the “Prepetition Loan Agreement”).

25. Pursuant to the Prepetition Loan Agreement, the Prepetition Lender agreed to fund up to \$15,000,000 to the Debtor on an incremental basis. The Debtor received its first advance of \$7,500,000 at Closing. Additional advances of \$2,500,000 and \$5,000,000, respectively, were to be made available when the Debtor reached certain financial benchmarks. The Debtor never reached those benchmarks and, as a result, neither the second nor the third advance was made.

26. Principal under the Prepetition Loan Agreement accrues interest at a floating rate equal to the greater of (a) twelve and one half of one percent (12.50%), and (b) the sum of (i) twelve and one half of one percent (12.50%), plus (ii) the Prime Rate minus four and three quarters of one percent (4.75%). The obligations evidenced by the Prepetition Loan Agreement

were scheduled to mature in 2017. On November 7, 2014, the Prepetition Lender issued a notice of default under the Prepetition Loan Agreement.

27. On March 11, 2014, the Debtor entered into a Securities Purchase Agreement pursuant to which certain institutional investors agreed to purchase \$9,993,680 in unsecured subordinated convertible debentures. Closing on the Securities Purchase Agreement occurred on April 24, 2014 at which time Baxano issued subordinated debentures convertible into common shares as \$1.06 per share and also issued warrants to purchase 9,428,000 common shares at \$1.19 per share. Interest on the convertible debentures accrues at 6% per annum and is payable monthly. The convertible debentures have a three year term and are subordinate to the Debtor's obligations under the Prepetition Loan Agreement.

28. On September 24, 2014, the Debtor obtained a bridge loan from one of the two institutional investors that participated in the subordinated convertible debentures. The Debtor received \$1.38 million in aggregate principal and issued similar subordinated convertible debentures. These debentures are convertible at \$.2421, which reflected the then current trading price of the Debtor's common stock. The convertible debentures earn interest at 11% which is payable quarterly. As a result of providing this loan, the institutional investor was given the right to exercise 2.3 million warrants at a \$.05 strike price, providing the Debtor approximately \$115,000 of proceeds, and to convert \$382,000 of its original subordinated convertible debentures at \$.05. This institutional investor has exercised the warrant for 2.3 million common shares at \$.05 per share and has converted \$384,000 of its original subordinated convertible debentures into approximately 7.6 common shares. The common shares received for the conversion as well as for exercise of the warrant were subject to resale to the public.

29. The Debtor estimates that \$4,108,560 is owed to unsecured trade vendors and suppliers.

C. Employees

30. As of the Petition Date, the Debtor employed approximately 20 employees, of whom 19 are full time employees (the “Full Time Employees”) and 1 is a part time employee (the “Part Time Employee” and, together with the Full Time Employees, the “Employees”). Not included in this employee count, but included in the payroll, are four hourly employees in the Debtor’s San Jose facility, each of whom will be terminated by the company on November 14, 2014 and employed by Venta, a critical vendor that is assuming the responsibility for manufacturing the Debtor’s iO product line.

31. Five of the 19 full time employees are paid on an hourly basis; 15 employees are salaried. Certain of the Employees are also entitled to reimbursement of expenses such as cell phone, travel expenses, meals and entertainment, employee relations, supplies and parts, and food and beverage products.

32. The Employees, including those employees being transferred to Venta, perform a variety of critical functions including, but not limited to, sales for the company’s products, distributor supervision, inventory management and product shipping, component procurement and product manufacture, maintenance of financial records and efforts supporting the sale of the Baxano assets. The Employees’ skills and their knowledge and understanding of Baxano’s operations, customer relations, and infrastructure are essential to the effective reorganization of the Debtor’s businesses.

33. The Employees are paid on a bi weekly basis. The first pay period following the Petition Date (the “Straddling Pay Period”) will end on November 15, 2014 for all employees. The payday for the Straddling Pay Period is November 14, 2014.

34. As noted, the Employees transferring to Venta will be terminated by Baxano on November 14, 2014. California law requires that these Employees be paid in full for wages and unused vacation as of their employment termination date. As a result, subject to approval of this Motion, Baxano’s payroll due on November 14, 2014 and/or November 28, 2014 will contain approximately \$4,327.97 (the “Transferring Employee Vacation Pay”) in prepetition unpaid vacation payable to the Employees being transferred to Venta.

35. The gross payroll for the Straddling Pay Period will be approximately \$181,107, of which less than \$151,000 (the “Pre-Petition Accrued Payroll”) will be on account of services rendered prior to the Petition Date. The Pre-Petition Accrued Payroll includes payments for five full time employees, each of whom were terminated prior to the Petition Date.

36. In addition, expense reimbursements on account of expenses incurred by Employees prior to the Petition Date (the “Pre-Petition Accrued Expense Reimbursements”) will be included in the payroll for the Straddling Pay Period and payrolls for subsequent pay periods in amounts the Debtor estimates will be less than \$35,000 in the aggregate.

37. During each pay period, (a) the Debtor deducts certain amounts from Employees’ paychecks, including, without limitation taxes, and garnishments for, among other things, child support, flexible spending account, deferred compensation, life insurance, health insurance and other benefits (collectively, the “Deductions”), and (b) forwards the amounts either to the appropriate third party recipients.

38. The Debtor estimates that, (a) as of the Petition Date, approximately \$16,500 in employee and employer non tax payroll Deductions for pay periods that ended prior to the Petition Date had not been forwarded to the appropriate recipient, and (b) the payroll for the Straddling Pay Period will include approximately \$14,500 in employee and employer non tax related payroll Deductions.

39. In addition, the Debtor estimates that as of the Petition Date, \$51,000 in employee and employer taxes for which Baxano is obligated on account of its Employees' earnings (the "Employer Payroll Taxes") have not been forwarded to the appropriate taxing authority. Employee and employer taxes to be included in the payroll for the Straddling Pay Period are approximately \$41,000.

III. THE DEBTOR'S FIRST DAY MOTIONS

40. As a result of the foregoing developments, the Debtor has commenced the Chapter 11 Case and filed various administrative and operational First Day Motions, as further described herein, with additional operational motions to be filed in the immediate future. Among the relief sought is interim and final approval of the DIP Financing. I believe, based on my personal knowledge of the Debtor's affairs and my conversations with certain of the Debtor's management, Employees, and advisors, that absent approval of the relief sought, including DIP Financing and the authorization to use cash collateral, the Debtor will be unable to continue operations on an uninterrupted basis, which in turn will jeopardize the Debtor's going concern value and any prospect of recovery to the Debtor's creditors.

41. I have formed opinions as to (a) the necessity of obtaining the relief sought by the Debtor in the First Day Motions, (b) the need for the Debtor to continue to effectively operate, and (c) the negative effects if the Debtor does not obtain the requested relief. My opinions are

based upon my first-hand experience, my review of the relevant documents, my discussions with other members of the Debtor's management team and the Debtor's advisors.

42. I reviewed each of the First Day Motions and participated in the preparation thereof I believe, to the best of my knowledge, that the facts set forth in the voluntary petition and the First Day Motions are true and correct. This representation is based upon information and belief and my thorough review of various materials and information, as well as my experience and knowledge of the Debtor's operations and financial condition. Based upon the foregoing, if called to testify, I could and would testify competently to the facts set forth in each of the First Day Motions.

43. The relief sought in the First Day Motions will minimize the adverse impact of this case on the Debtor's customers, Employees, and suppliers, while allowing the Debtor to maximize value for its creditors. I believe that the relief sought in the First Day Motions is necessary to enable the Debtor to operate effectively as a debtor-in-possession.

44. Some of the First Day Motions request authority to pay or otherwise honor certain prepetition claims. I am advised that Rule 6003 of the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules") provides that "except to the extent relief is necessary to avoid immediate and irreparable harm," the court shall not consider motions to pay prepetition claims during the first twenty (20) days after the filing of a petition. As set forth in more detail below and in the First Day Motions, I believe that the Debtor's requests for authority to pay prepetition claims are narrowly tailored to those circumstances where the failure to pay such claims would bring immediate and irreparable harm, or which would otherwise be entitled to administrative priority under the Bankruptcy Code.

A. Operational Motions

Motion to Pay Employee Wages, Benefits and Withholdings

45. The Debtor requests an order authorizing, subject to the terms and conditions of the DIP Credit Agreement, but not directing, the Debtor to pay or otherwise honor prepetition wages and salaries, and prepetition obligations, arising under various employee benefit and insurance programs, including reimbursable expenses, subject to caps set forth in the motion. The Debtor seeks this relief to minimize the personal hardship that the Debtor's employees would suffer if prepetition employer-related obligations are not paid. The Debtor further seeks authority to continue various employee benefit and insurance programs, as further described in the motion, in the ordinary course of business.

46. The Debtor has costs and obligations with respect to its Employees relating to the period prior to the Petition Date. The Debtor requests authority to pay any wages and salaries accrued, but unpaid prepetition, on a postpetition basis, in an amount not to exceed \$12,745.00 on an individual basis. The Debtor also seeks authority to continue its employee benefit programs, including reimbursement of certain expenses incurred by Employees, and generally make payments related thereto, in the ordinary course of business.

47. The Debtor is required by law to withhold certain amounts from its Employees' wages and to remit the same to the appropriate taxing authorities. These withholding amounts relate to, for the Debtor's Employees, federal, state, and local income taxes, as well as social security and Medicare taxes. The Debtor may also be required to withhold amounts from the Employees' wages for such items as court ordered child support payments, other attachments to wages, and government mandated savings plans. In addition, the Debtor is required to make contributions of its own funds to the taxing authorities in the form of matching payments for its Employees on account of social security and Medicare taxes and to pay, based on a percentage of

gross payroll and subject to state-imposed limits, additional amounts for, among other things, state and federal unemployment insurance. I believe that the current practice of directing such funds to the appropriate parties is in the ordinary course of business and appropriate on a postpetition basis.

48. There can be no doubt that the Debtor's Employees are a substantial component to the uninterrupted operation of the Debtor's business during this Chapter 11 Case. For these reasons and the others described more thoroughly in the motion, I believe the relief sought in this motion is necessary to avoid immediate and irreparable harm, including, but not limited to, the loss of Employees and the potential shutdown of operations.

DIP Credit Agreement/Cash Collateral Motion

49. The Debtor has obtained a \$350,000 DIP credit facility from the Prepetition Lender that will allow the Debtor to operate during this Chapter 11 Case. The Debtor has also obtained agreed terms for its use of cash collateral with the Prepetition Lender.

50. I believe that the DIP Credit Agreement represents the best (and, in fact, only) terms currently available to the Debtor, and that the financing being provided by the Prepetition Lender (including the use of cash collateral) is necessary to continue operations postpetition and consummate a going concern sale of the Debtor's assets.

51. The DIP Credit Agreement is critical to the success of this case. It is therefore necessary for the Debtor to obtain new liquidity, substantially on the terms provided in the DIP Credit Agreement, and be permitted to use cash collateral, to maintain its business operations, and in turn, the going concern value of this estate pending consummation of a sale. Absent the financing provided for in the DIP Credit Agreement, I believe that the Debtor will soon not be able to meet its direct operating expenses and would face the prospect of a complete cessation of

operations and liquidation. Such a result would undoubtedly cause immediate and irreparable harm to this estate by eliminating going concern value and any possibility of completing the sale, all to the detriment of the Debtor's creditors and stakeholders.

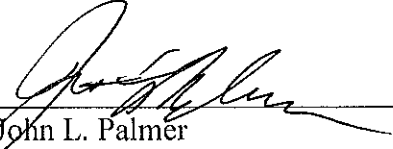
52. I believe that the Debtor is unable to procure financing in the form of unsecured credit allowable under Section 503(b)(1) of the Bankruptcy Code, as an administrative expense under Section 364(a) or (b) of the Bankruptcy Code, or in exchange for the grant of an administrative expense priority pursuant to Section 364(c)(1) of the Bankruptcy Code, without the grant of liens on assets. Despite making requests to at least three (3) separate potential sources, the Debtor has been unable to procure any offers to provide debtor-in-possession financing, let alone on terms more favorable than the financing offered by the Prepetition Lender pursuant to the DIP Termsheet. Moreover, given that (a) the Prepetition Lender, who has a perfected security interest in substantially all of the Debtor's assets, will be providing the DIP Financing and, in its capacity as the Prepetition Lender, has consented to the priming of the Prepetition Security Interests by the liens provided to secure the DIP Financing, and (b) the Prepetition Lender has advised that it will not consent to the priming of its Prepetition Security Interest to liens securing debtor-in-possession financing provided by any other lender, I do not believe that it is reasonable to believe that any other debtor-in-possession financing can be secured by the Debtor.

53. For these reasons and as more thoroughly provided in the motion, I believe, and the Debtor submits, that the relief requested in this motion is in the best interests of the Debtor, its estate, and its creditors and should therefore be approved.

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I declare under penalty of perjury that the foregoing is true and correct to the best of my knowledge, information and belief.

Date: November 13, 2014

By: 
John L. Palmer