BANKRUPTCY INSIGHTS

Article 9 Sale Process for Intangible Assets:

A Cost-Effective, Efficient Option for Disposition of Collateral

BY RICHELLE KALNIT

As the cost of bankruptcy continues to increase, in particular due to fees and expenses associated with administering bankruptcy cases, secured lenders are increasingly turning to foreclosures under Article 9 of the Uniform Commercial Code (UCC) as a preferred vehicle for disposing of their collateral. While Article 9 can be utilized across the spectrum to liquidate any type of collateral, it is a particularly useful tool for disposing of intangible assets, as many of these assets can be legally transferred, and also delivered, by legal assignment.

During the COVID-19 pandemic, when many state courts were less accessible to address state court receivership sales, lenders increasingly explored Article 9 as a method for disposing of or owning collateral. It continues to serve as an important tool in the toolbox of getting paid following a loan default.

During the last two years, the lending community has exercised an incredible amount of patience with borrowers, and, as cash flooded the market, borrowers were able to raise additional financing. Yet, as the effects of supply chain challenges continue to reverberate throughout the market, we expect that certain lenders may no longer continue to support troubled borrowers. For those most impacted by the supply chain disruptions, the additional funding will dry up, causing senior lenders to more seriously consider their options. In preparation for that, lenders should be well-versed in the benefits of Article 9 foreclosures as part of the suite of options available to them.

Why Article 9?

Lenders are well-aware of the myriad options available to them if they need to dispose of assets belonging to a troubled borrower. A Chapter 11 bankruptcy is certainly well established as capable of achieving favorable outcomes for sellers and buyers of assets, and providing buyers with a "free and clear" sale order, but often at the expense of lenders who need to fund a budget to achieve a sale transaction. The Chapter 11 process is often unavoidable however, due to the protections of the automatic stay provided to debtors and, in more complex cases, its utility in bringing parties in complex capital structures together.

For lenders owed a smaller dollar amount (typically $5 million or less) however, Chapter 11 is often simply not cost-effective. In such cases, lenders often consider liquidating collateral through other means, including through a receivership, an assignment for the benefit of creditors, a subchapter V bankruptcy case, or through a Chapter 7 bankruptcy case. While these options may provide solutions for lenders in certain circumstances, the lender loses an element of control over the process with each of these, as they all involve an intermediary (receiver, assignee, or Chapter 7 trustee) who will take control of the assets or an additional layer of supervision (subchapter V trustee). Moreover, in a subchapter V case, the debtor is still required to go through the plan process, and because the statute is relatively new, having been enacted in February 2020, it presents some unknowns. In cases of alleged fraud or misconduct, third-party control over a process may be necessary, but in most cases involving troubled loans, lenders seek to maintain an element of control over the process in which the collateral is liquidated for their benefit.

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This is where Article 9 provides a number of benefits for secured lenders. For certain classes of assets in particular, as discussed below, Article 9 offers the value-maximizing outcome of a sale event in a timely fashion, while minimizing cost. It allows the lender to maintain control of the process and maximum flexibility to see it through to a conclusion of a public auction, or pivot and test the market before trading its debt.

Piecing Together a Transaction: What Does it Look Like?

Article 9 foreclosures can be a useful tool to monetize a going-concern operation. In that circumstance, the sun, moon and stars need to align such that the assets are preserved as a going concern and the borrower is committed to achieving a favorable outcome. In transaction documents evidencing a going concern or quasi-going concern transaction, the lender may also need to be willing to make certain representations and warranties customary of a going concern transaction. This certainly can occur, and when it does, the fees associated with such a transaction tend to be considerably less than when a similar transaction is achieved through a bankruptcy. However, these types of transactions tend to be relatively rare unicorns.

More typically, by the time that a lender explores the option of Article 9, the business has started to come apart at the seams, or worse. Perhaps there are key vendors who are owed money and who are no longer performing absent payment on past due amounts, or a warehouse is holding inventory pending payment of overdue rent. Perhaps relationships with the borrower have soured. In those circumstances, Article 9 can serve as a particularly useful vehicle for disposing of intangible assets because what a lender can deliver, and what a buyer needs in order to utilize the assets, are complementary.

Specifically, one of the challenges in consummating an Article 9 transaction is that lenders are not willing to go beyond an "as is, where is" sale, with good reason. Typically, they are not in a position to make representations and warranties and, moreover, they cannot provide a title representation (of course, lenders do not have title to the assets, the borrowers do), and they rarely have possession of the assets that are part of the deal. However, when it comes to intangible assets, such as trademarks, patents and copyrights, these assets can be transferred by assignment, and the delivery of the assignment gives the purchaser the requisite right to update the records at the United States Patent and Trademark Office, giving the buyer everything that it needs in order to utilize the intellectual property.

Taking possession of domain names can be slightly more complicated, depending on the borrower's level of cooperation. While a lender can deliver a domain name assignment, without transferring the domain name itself to the buyer's chosen domain name registrar, the buyer is not able to actually utilize the domain name. However, if the buyer receives an assignment of the related trademark, and the borrower refuses to transfer the domain name itself, the buyer could consider bringing a subsequent Uniform Domain Name Dispute Resolution Policy (UDRP) action against the borrower to obtain possession of the domain name.

It seems that counterparties to software licenses have done a good job of providing for access to source code of software via a source code escrow. If a lender has a source code escrow, it will be better positioned to deliver software collateral to a buyer than if it does not. Lenders should ensure their loan documents permit release of the escrow upon certain triggering events, one of which could include the closing of an Article 9 sale.

Creative Techniques to Encourage Borrower Cooperation

As noted above, the extent of a borrower's cooperation can be an important component in how the transaction is assembled, the extent of diligence that can be offered and whether there is a company representative available to engage in management calls with potential buyers regarding historic and possible uses of the assets. The sale process undoubtedly runs more smoothly with a cooperative borrower than with a borrower who not only is uncooperative, but for whom the threat of a process-delaying bankruptcy hangs overhead.

Lenders should think creatively about how best to encourage cooperation from borrowers to maximize value and de-risk a transaction. This may include waiving rights with respect to certain collateral, or against personal guarantees, if the borrower cooperates through the conclusion of the process. The borrower also may be motivated to cooperate by the opportunity to provide transition services or gain employment from the buyer.

Sale Process Techniques for Maximizing Value in a Sale of Debt or Auction

Conducting a sale process pursuant to Article 9 provides the lender with a great deal of information about the value of the assets, including in the time period leading up to the public auction. The level of interest generated from the sale, as well as the discussions with potential buyers, allow the lender to have insights that it would not have had prior to the outset of the process.

These insights give the lender optionality when it comes to a desired path for payment in the event the lender is not looking to own the asset. And, if the lender is looking to own the asset, the process gives the lender information about potential go-forward partners.

The lender may choose to engage in pre-auction discussions about the sale of debt. A pre-auction sale of the debt gives the lender certainty of payment and provides the purchaser with a potential arbitrage, because the debt often trades at a discount, but the debt purchaser is able to credit-bid the full face amount of the debt. The discussions with potential buyers as part of the Article 9 sale process often open the door to a pre-auction debt sale.

Alternatively, the lender may choose to move forward with the public auction. In that case, it also has a great deal of information about the dynamics of the process and the interested parties, having likely been on the receiving end of diligence requests from potential buyers with which it is now well-familiar. Creative lenders will utilize this information to create an auction format that encourages the auction participants to reveal their willingness to pay. They may also choose to credit-bid as a way to set a floor for further bidding, creating additional value-maximizing auction dynamics.

In Conclusion

COVID-19-induced supply chain challenges are likely to continue to put strain on certain credits. The longer these challenges persist, the more likely it is that defaults will force lenders to exercise remedies. As lenders consider their alternatives, Article 9 of the UCC provides an attractive option for liquidating collateral, in particular, intangible assets, and ultimately, getting paid.

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