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IP Financing Deals Gain Traction For Companies Seeking Liquidity

Davis Polk's Frank Azzopardi explains how IP financing tools now offer a more evolved route for companies to securitize rights in IP assets.

Companies increasingly seek novel ways to collateralize and securitize their rights in intellectual property and other intangible assets. While this trend began with traditional royalty securitizations in the music and pharmaceutical industries, such as Bowie Bonds in the late 1990s, deal technology has grown more sophisticated and is now being used across a wider array of industries.

These transactions include a variety of asset-backed financings, secured notes offerings, and other methods such as whole-business and digital infrastructure securitizations. This expansion has allowed companies to unlock value in IP assets to meet their most pressing liquidity needs.

Recent market forces, including constraints on capital markets, a less favorable interest rate environment for borrowers, and investor appetite for creative ways to deploy capital, have only further piqued interest in these transactions.

How They Work

A fundamental premise underpinning the structure of these transactions is that the company's IP assets, which are pledged as collateral, must be critical to the company's business in some shape or form.

On this basis, a "mouse-trap" is built that could deprive a company of these critical assets in the event of its default (but not before). The structure is designed to withstand attack in bankruptcy.

Prior to any event of default, it's business as usual for a company. However, upon any default, the company faces untenable loss or impairment of those essential IP assets unless it takes steps to preserve the transaction structure for the benefit of secured parties.

At the same time, from the perspective of secured parties, the collateral is most valuable when used in the company's business, making any foreclosure a suboptimal outcome. The resulting tension is one of mutually assured destruction, and is designed to ensure all parties act rationally when exercising their rights and remedies.

In recent airline loyalty program financing transactions, which arguably saved the airline industry during the Covid-19 pandemic, the IP assets pledged as collateral were airlines' critically important frequent flier program assets. Airlines need their loyalty programs to be a going concern, and bondholders need operating airlines to give their collateral its fullest value—so those assets were the perfect fit for this type of structure.

In those airline loyalty program financings, the pledged IP assets were transferred to one or more special-purpose vehicles—whose shares were also pledged as part of a broader package of protections—and golden shares were issued to veto any bankruptcy filing with respect to those entities.

In this way, bankruptcy remoteness was achieved by keeping holders of IP assets out of bankruptcy and preserving the secured parties' interest therein.

An emerging alternative structure, which uses a leaner form of deal technology, involves leveraging certain protections provided by the US Bankruptcy Code and, in particular, the operation of Section 365(n) and a recent US Supreme Court ruling in the *Mission Products* case. These protections allow a licensee of certain IP rights to retain its license (including exclusivity) in the event the license agreement is rejected in the licensor's bankruptcy.

In this paradigm, rather than keep the holder of the IP assets out of bankruptcy, an exclusive license granted to a collateral agent serves as a poison pill. Here, unlike the special-purpose vehicle structure, there is no major corporate reorganization or intercompany transfer of IP assets, which may be prohibited by preexisting credit facilities or cause tax inefficiencies.

The collateral agent, once granted the exclusive license, then sublicenses the critical IP assets back to the company so that it can operate its business without disruption. This sublicense is maintained prior to any default.

However, a parade of horribles ensues if protections afforded to secured parties are attacked, as the exclusive license to the collateral agent can be preserved in bankruptcy by virtue of the Bankruptcy Code. The sublicense back to the company could be extinguished if the transaction were rejected by the company, severing the company's freedom to use these critical IP assets.

Benefits

Increased market understanding of, and comfort with, these structures helps explain growing interest in these transactions. In particular, ratings agencies understand the mechanics of this deal technology and usually provide a company with a ratings lift if satisfied that the additional protections operate as designed.

Additionally, IP assets are non-rivalrous and highly divisible (unlike physical property, they can be shared by multiple users simultaneously without detracting from the other's use). This allows them to be shared, split, licensed, and transferred in ways that aren't possible with other forms of collateral. This dynamic allows for greater creativity when structuring these financing arrangements.

From an operational perspective, this inherent flexibility makes these transactions attractive to both companies and secured parties, as it enables them to build bespoke structures that cater to the specific needs of a particular deal. It's never a one-size-fits-all approach.

Finally, since these IP assets are often foundational to a company's income-generating activities, these structures can have the further added benefit of providing an opportunity to engage in, or reevaluate, tax planning through use of transfer pricing within their corporate structures.

We can expect continued growth and innovation in this space with this wider market acceptance of such deal structures, and the ability for companies to unlock value from an untapped source to help meet their liquidity needs.

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