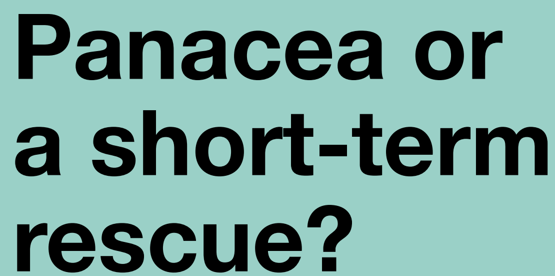

Panacea or a short-term rescue?

Eric S Chafetz discusses the impact of retailers transferring intellectual property assets to unrestricted subsidiaries

The retail sector in the US is undergoing a tectonic shift away from brick and mortar stores to an internet-based retail paradigm. The historical big box players like Best Buy, J Crew, Sears/ Kmart and Wal-Mart, to name a few, have been late to the game in countering Amazon's dominance online, and it is unclear whether they can ever catch up. This has resulted in numerous value-destroying retail bankruptcies (mostly liquidations or piecemeal sales, instead of reorganisations) including, among many others, Circuit City, Linens & Things, American Apparel (twice in 13 months), Sports Authority, Borders and Blockbuster Video.

Recently, a few struggling retailers – J Crew Group, Inc ("J Crew"), Gymboree and Claire's Stores, Inc – may have found a way to stave off an immediate bankruptcy filing by taking a page out of a playbook used by Sears, Roebuck and Co's ("Sears") and non-retailers such as Sprint Corp, IHeart Media, Inc, and Caesars Entertainment Operating Company, Inc ("Caesars"). These retailers have transferred or may transfer their intellectual property (brand and trade names, web domains, mobile apps, etc) and other assets to unrestricted subsidiaries and outside of their existing lenders' collateral packages.[1]

Companies have been monetising their intellectual property assets for many years. However, the strategy retailers have recently pursued is unprecedented. As a research analyst from RW Pressprich & Co observed in Bloomberg, while "[t]here may be other situations [like Sears, where similar transfers have been made],…we haven't seen retail companies using IP assets and investment baskets[2] like this before…". Further, the companies "are taking advantage of valuable assets that haven't been optimally utilised to find new creative ways to create liquidity to extend their existence."

There is no guarantee that the intellectual property transfers will not be challenged or unwound (IHeart Media, Inc and Caesars each had transfers challenged). It is also not exactly clear what a company can do with the intellectual property after it is transferred to an unrestricted subsidiary. The answers to these questions are entirely dependent on the specific language in a borrower's credit agreement or indenture and the facts surrounding the transfers. If authorised, the transfers may provide significant value to a struggling retailer by (a) allowing the retailer to raise new financing to buy back its loans and bonds at discounted prices using the intellectual property as security for the financing or (b) allowing existing loan and debt holders to swap into the debt of the new unrestricted subsidiary that owns the intellectual property. This is to the detriment of the existing lenders who lose potentially valuable intellectual property collateral, which oftentimes is a retailer's crown jewel.

The transfer of intellectual property assets may initially create value and prolong the existence of a retailer. However, this strategy may also have unanticipated consequences if the company files for Chapter 11 bankruptcy protection and only certain lenders have liens on its intellectual property.

Historical monetisation of intellectual property assets

A. Bonds

According to Bloomberg, the first intellectual property bonds were issued in 1997 and secured by 300 David Bowie songs. Bowie issued $55m in Bowie bonds with the interest covered by royalty payments from the songs. Thirty similar bond deals were subsequently closed. In addition, film studios have issued bonds secured by future revenue streams, as have fashion designers and retailers (including Bill Blass and BCBG Max Azria Group). Likewise, Arby's Restaurant Group, Dunkin Donuts and other restaurant chains have issued bonds secured by outside franchising fees.

B. Sears

Sears was one of the first retailers to monetise its intellectual property assets by transferring them to an unrestricted subsidiary.[3] As part of the 2006 transfer, Sears completed a S$1.8bn securitisation of certain intellectual property including some of its biggest brand names – Kenmore, Craftsman[4] and DieHard. One commentator has observed that the brands were transferred to a Sears insurance subsidiary based in Bermuda in an effort to protect them from a potential future bankruptcy proceeding. According to Sears, however, it created the bonds to hedge against any future financial trouble at the insurer. As Bloomberg observed, the transaction was unique because, unlike prior intellectual property monetisation transactions, it did not involve pre-existing royalty payments or cash being paid contemporaneously to purchase bonds. Instead, the transaction had the effect of walling off the intellectual property from Sears' existing lenders.

J Crew and other recent retailers

More recently, the iconic retailer J Crew transferred its intellectual property assets to an unrestricted Cayman Island subsidiary in conjunction with addressing a $3bn debt load. However, as the R W Pressprich analyst observed, unlike Sears, J Crew relied on investment baskets allowed under its credit agreement to justify the transfer. In a 12 December, 2016 analysis, Covenant Review, LLC ("Covenant

Review") concluded that J Crew's transfer of its intellectual property to an unrestricted subsidiary was likely appropriate under its loan agreement, but that without additional information it could not confirm what J Crew can and cannot do with the intellectual property after the transfer. According to Covenant Review, this depends on whether the unrestricted subsidiary is newly designated or pre-existing (which at the time of the analysis was unknown) and whether J Crew solely intends to assign the intellectual property to the unrestricted subsidiary or to conduct a securitisation financing with the intellectual property.

Debtwire also recently reported that Gymboree's term-loan holders are very worried that they could be "J Crewed." Similarly, Bloomberg has reported that Claire's Stores, Inc recently tied term loans to a new unit whose assets include stakes in the company's brands, domain names and mobile apps.

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Impact of an intellectual property transfer in retail bankruptcies

The transfer of intellectual property assets to an unrestricted subsidiary may have unanticipated consequences in bankruptcy. It could have a significant impact on a plan of reorganisation, a Section 363 sale process or liquidation (the latter two scenarios being the more likely in a retail bankruptcy), especially if the debtor's intellectual property is encumbered by the liens and security interests of only a subset of lenders.

American Apparel's second bankruptcy filing in 13 months was not preceded by the transfer of intellectual property assets. However, the case highlights some of the issues and questions J Crew and other similarly situated retailers may face in a bankruptcy.

Before the filing date, the American Apparel debtors reached an approximately $60m deal with Gildan Activewear Inc ("Gildan") to act as a stalking horse for the purchase of American Apparel's intellectual property assets and manufacturing equipment (with an option to buy certain wholesale inventory) through a bankruptcy sale. After an auction between Gildan and at least one other bidder, Gildan increased its offer to approximately $103m, with approximately $88m allocated to the intellectual property assets and manufacturing equipment, and approximately $15m allocated to wholesale inventory. Gildan did not purchase any American Apparel retail locations. As discussed in the American Apparel debtors' DIP financing motion, only two of American Apparel's three lender groups had liens on American Apparel's intellectual property assets, while the third lender group had a lien on other categories of assets.

This raises several very interesting questions. As Gildan's bid was the winning bid at auction, how will the third lender group without a lien on intellectual property fare during the liquidation of the remaining assets? Will that lender group recover more or less on their claims than the lenders with a lien on intellectual property assets? Did Gildan's stalking horse non-going concern offer prevent the American Apparel debtors from receiving any going concern offers that included retail stores leases? Did any disagreements arise between the three groups of lenders when valuing the competing offers made during the auction? Or does the outcome of this auction signal yet another nail in the brick-and-mortar retail industry's coffin? And, if so, might it encourage more retailers to transfer their intellectual property or engage in other non-conventional strategies to extend their existence (artificially or otherwise)? While it is very difficult to conclusively determine the answers to some of these questions, the results of the American Apparel sale process and interactions between the competing lenders may be helpful in predicting the outcome of a sale process in a bankruptcy filed by a retailer such as J Crew, Gymboree, or Claire's Stores, Inc.

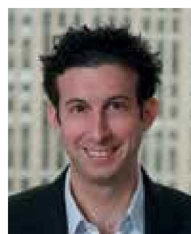
Summary

It is too early to tell whether any of those retailers will file for bankruptcy and, if they do, what impact the transfer of intellectual property assets might have. However, it is likely that lenders in the future will add unambiguous covenants to credit agreements and indentures forbidding the use of investment baskets to transfer intellectual property assets to an unrestricted subsidiary under all, or the vast majority of, circumstances. Or, if such transfers are allowed, the credit agreements will require that the lenders' liens and security interests follow the transferred assets. Due to the rapid migration to an internet-based retail economy, many recent retail bankruptcy cases have left lenders underwater and struggling to recover on their claims. Intellectual property assets have significant value in retail cases, and lenders would be remiss if they did not take steps to ensure that those assets will not leak out of their collateral packages.

Footnotes

1. An unrestricted subsidiary is one that is not considered necessary to support the repayment of a loan and is not subject to the terms of the loan documents. Loan covenants will oftentimes limit the amount of assets and money that can be distributed to an unrestricted subsidiary by a borrower and its restricted subsidiaries (ie, loans dividends, asset transfers and capital contributions). More creditworthy borrowers can negotiate with their lenders to allow for some level of transfers to unrestricted subsidiaries.
2. A "basket" is an agreed exception to a negative covenant in a loan. And, an "investment basket", allows the borrower to invest funds in various ways under certain circumstances and up to certain levels.
3. It is unclear exactly what provisions Sears relied upon in its credit agreement to authorise the transfer, but the overall terms of the credit agreement were extremely borrower friendly.
4. Just recently, Stanley Black & Decker purchased the Craftsman brand.

Author



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