The Post-Industrial World Of Chapter 11

By Jonathan Friedland and Marc Fineman

Post-industrial: Of or relating to a society or economy marked by a lessened importance of manufacturing and an increase of services, information, and research; "postindustrial countries."

The year was 1967. The Beatles released Sgt. Pepper, the federal debt was a mere $380 billion, China announced it had the bomb and the U.S. was still predominantly a manufacturing economy. And, yes, "The Graduate" came out, starring a very young Dustin Hoffman.

Today, a good amount of the intellectual property that makes *stuff* is still (at least for now) invented here, the actual *stuff* tends to be made elsewhere (note: beginning in 2008 and continuing through 2010, the number of U.S. patents granted for foreign inventions surpassed the number of U.S. patents granted for U.S. inventions; 2011 statistics are not yet available). Given our nation's continued post-industrial trend, one might reasonably expect more and more bankruptcies involving companies whose principal assets are intellectual property rather than textiles, metal and yes, plastics. Even hard-asset-heavy companies will also tend more and more to also have valuable intellectual property.

A good bankruptcy case to keep an eye on to see how an intellectual-property-heavy case will do is Kodak, with its more than 20,000 intellectual property filings, including issued patents, registered trademarks and pending applications in 160 countries. The patent market is especially hot right now. Non-practicing entities (or, as some call them, patent trolls) are competing with strategic buyers, especially where there is a hint of potential infringement. There is certainly much discussion in the blogosphere about the implications of this trend on innovation and research and development investment. But that's a different topic for a different day.

What is really interesting is the prospect of buying the "essence" of a company without buying all the other stuff, and doing so outside of bankruptcy is also pretty interesting. Taking a step back, here's what we mean: The main reason buyers buy "substantially all of the assets" of distressed businesses instead of their equity is to avoid picking up all of the distressed company's liabilities—that's basic stuff. And, when buyers can get comfortable, they will sometimes buy outside of bankruptcy (we know we like to), but it is undeniable that successor liability risks exist, at least to some extent, whenever one buys outside of bankruptcy. But what if you don't need all of the assets? What if you only need the intellectual property?

What is a company? In the case of a farm, the land is pretty important, but what about a bookstore? Do you really need the leases? Commercial real estate is cheap. Employees? The unemployment rate is still pretty high. Books? Show publishers the money and you can restock pretty fast. In the Borders Chapter 11 case, the asset that got the most attention was the intellectual property: the name, website, customer list—stuff like that. Circuit City went bankrupt a few years ago and the name was swept up pretty quickly. Same with Sharper Image and dozens of others, and every case we have ever been in or read that dealt with successor liability issues involved a buyer of "substantially all" of another company's assets. We simply have not seen any successor liability cases against an entity that bought *only* the intellectual property of another company.

While intellectual property can be sold separately and apart from the enterprise, our experience indicates that— at least on the consumer side—higher values will be realized when customer engagement is maintained throughout the sale process. Buyers will discount the value of the intellectual property as the customer relationship becomes more attenuated. We generally advise our lender/old equity clients that in a wind-down scenario, they need to be prepared to "invest" in keeping the process as orderly as possible in order to generate maximum recoveries. The opposite can be true when advising a buyer.

A buyer who wants the essence of a company at a lower cost and less risk should consider buying just the intellectual property, whether in or out of bankruptcy. This is not good for the distressed business or its creditors, but where hard assets and contractual relationships (other than the intellectual property licenses) are not considered critical, it just might be the best way to go.

This is not to say there are no other issues that could derail one's efforts. Indeed, the Federal Trade Commission, attorneys general and other consumer-protection groups have been very active in most of the recent Chapter 11 cases in which customer data and loyalty metrics were sold. But at the end of the day, these additional considerations should not impair one's ability to consummate a purchase of the debtor's intellectual property for significantly less than the bricks, mortar and machinery that constitute the debtor's going-concern operation.