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Ensuring Positive Outcomes with Negative Pledges in Venture Lending

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A "negative pledge" on intellectual property is a common feature of venture lending transactions, but its implications can often be misunderstood. Some lenders may be surprised to discover that it does not always provide the protection they may expect in post-default scenarios.

This alert cautions venture lenders to carefully consider the limitations of relying on a negative pledge and offers practical steps for lenders to strengthen their collateral position when doing so.

Background

Intellectual property is often the primary asset for emerging growth companies, be it the source code underlying a SaaS developer's software platform or a biopharmaceutical company's patented gene therapy.

Given its role in the business, many companies seek to carve out their intellectual property from the general requirement that borrowers under senior secured credit facilities grant their lenders a security interest in all of their assets.

Rather than granting the lender a security interest in its intellectual property, a borrower under a so-called negative pledge arrangement instead agrees not to grant a security interest in its intellectual property to anyone else.

The intellectual property is thus excluded from the lender's collateral package, effectively rendering the lender an unsecured creditor vis-à-vis the borrower's intellectual property without the streamlined remedies of Article 9 of the Uniform Commercial Code.

From the borrower's perspective, the negative pledge is likely preferable to an outright grant of a security interest in intellectual property because it shields the company's "crown jewels" from the reach of its secured creditors.

Venture lenders, for their part, may find the negative pledge provides sufficient protection against interference from other creditors in a workout or enforcement situation, or that the forgone security interest provides only minimal credit enhancement (*ie*, a borrower's intellectual property is unlikely to provide for a significant recovery in post-default enforcement proceedings).

In situations where a stronger credit is considering multiple financing proposals, lenders might feel compelled to concede a security interest in intellectual property to remain competitive with other financing sources.

Limitations of Negative Pledges

Borrowers and lenders alike are often content with this arrangement in smooth sailing, but a negative pledge has the potential to become problematic when waters get choppy. For example, a borrower in desperate need of funding might violate the negative pledge to obtain rescue financing from a third party.

Such a violation would give rise to a claim against the borrower for breach of contract rather than the avoidance of the improperly granted lien, and this claim is usually of limited or no value because (a) it requires time-consuming and expensive litigation to pursue and (b) even if the incumbent lender ultimately is successful, the resulting judgment is unlikely to be recoverable, given that the borrower may have few, if any, unencumbered assets with which to satisfy such a judgment.

In theory, certain claims (in tort or otherwise) may be brought against the borrower's board of directors or a third-party lender who knowingly takes a lien over intellectual property in violation of the negative pledge. Similar to claims for breach of contract, such actions are expensive and rarely pursued in practice.

The situation is further complicated when the borrower files bankruptcy. In a bankruptcy case, the debtor-borrower may seek to obtain debtor-in-possession (DIP) financing secured by the unencumbered intellectual property, and the bankruptcy court is likely to approve the granting of liens on such intellectual property notwithstanding the negative pledge, especially if the debtor-borrower is otherwise unable to secure DIP financing on reasonable terms, as is often the case.

Similarly, the debtor-borrower in bankruptcy may be able to monetize the intellectual property, despite the negative pledge, by selling or licensing it to a third party. In such cases, the bankruptcy court is likely to be swayed by the debtor-borrower's arguments that, without such financing, the reorganization is likely to fail, in which case all creditors, including the secured lender with the negative pledge, will be harmed.

Courts facing hard choices like these are likely to find that, without a perfected lien on the intellectual property, the secured lender with the negative pledge lacks an interest in the intellectual property that is entitled to "adequate protection" under the Bankruptcy Code.

Practical Considerations

Little can be done from a documentation perspective to prevent a borrower's intentional breach of its contractual obligations, but lenders can take steps to mitigate the risks of excluding intellectual property from its collateral package before an enforcement scenario arises.

Diligence

Appropriate diligence would uncover the scope of a borrower's federally registered intellectual property and whether there are any legal challenges or allegations of infringement that might impact its value or utility to the

business. Lenders are encouraged to use this information to more broadly understand the company's approach to and strategy for its intellectual property, including its relative importance (in terms of historical performance and go-forward operating expectations) and value (both as a going concern and in a liquidation scenario).

Lenders may further seek to confirm whether the borrower is restricted from granting security interests in any of its licensed intellectual property under the terms of the related licensing agreements and consider any incremental risks arising from such provisions.

Credit Documentation

Lenders are encouraged to evaluate the scope of the representations regarding intellectual property in the credit documentation to ensure they provide adequate protection in light of the borrower's business strategy and its reliance on its intellectual property.

Lenders are also encouraged to ensure that the reporting it receives regarding the borrower's intellectual property portfolio provides sufficient visibility into the borrower's intellectual property assets.

When agreeing to rely on a negative pledge, prudent lenders will confirm that the related covenants in the credit documentation are properly crafted. For instance, venture lenders will typically include a "double negative pledge" covenant that prohibits the borrower from granting a negative pledge on its intellectual property to third parties to ensure it can later take security in the borrower's intellectual property without triggering a default under the borrower's other agreements.

Additionally, lenders take care to ensure that the borrower is not able to use the disposition or asset sale covenant to dispose of material intellectual property that it would be unable to finance due to the negative pledge. Lenders may pay particular attention for potential loopholes when a borrower has (or could in the future have) subsidiaries that are not loan parties under the credit facility. As a result of this concern, "immaterial subsidiaries" or similar non-loan parties are often prohibited from owning material intellectual property.

Lastly, lenders may want to confirm that the obligations secured by the borrower's collateral would include any potential judgment for breach of contract resulting from the borrower's violation of the negative pledge. If covered (and assuming the value of the borrower's collateral exceeds the amount owed to the lender), the lender may be able to exercise remedies against the borrower's other assets to satisfy its judgment. This determination may hinge on the loan agreement's indemnification and expense reimbursement provisions, which courts often interpret narrowly, so clarity is key.

Changes in Collateral

Some lenders may seek to strengthen their collateral position with respect to intellectual property as a borrower experiences significant distress, often in connection with agreeing to forbear against or waive an existing default. This may be appropriate in some circumstances, though lenders should do so only after considering any potential reputational risks, given the relational aspects of the venture lending market and any potential fraudulent transfer and preference issues that might enable a bankruptcy trustee to "claw back" certain transfers of property, including liens, made by the borrower prior to bankruptcy.

Alternatives to a Negative Pledge

Creative lenders may sometimes prefer something other than a pure negative pledge arrangement.

For example, some lenders may incorporate a "springing lien" concept, whereby the borrower is required to grant a security interest in its intellectual property upon the occurrence of certain trigger events (such as the outstanding loans exceeding a specified threshold or the breach of certain financial performance metrics).

While not common in the venture lending space, venture lenders could alternatively incorporate a "release price" mechanic, commonly used in real estate development transactions, where the borrower is able to release a portion of its lien upon an agreed paydown of the outstanding loans or the satisfaction of other conditions.

These approaches move past a binary decision of whether to include (or exclude) intellectual property as collateral, but may entail delicate discussions in advance of closing when they are sensitive to their leverage and negotiating position and may have other shortcomings, depending on the circumstances.

If you would like to discuss or have any questions regarding the topics discussed in this alert or related matters, please contact one of the authors or another member of DLA Piper's Restructuring or Venture and Growth Lending teams.