

SECURED FINANCING WITH INTELLECTUAL PROPERTY: Managing Uncertainties

“Intellectual property used to be the tail that failed to wag the dog in commercial transactions. Now it is the dog itself.”¹

The above quote dates back to 1982, but in many areas we are still trying to catch-up with this new reality. When intellectual property takes a central role in commercial transactions, some unique challenges arise – most of which arise from the lack of familiarity with the nature of these types of property among businesspersons, bankers, investors and lawyers. The valuation of intellectual property and the perfection of security interests in intellectual property are two areas in which we are still trying to catch-up.

The valuation of intellectual property is still highly uncertain today. There are two primary reasons for this. First, unlike real property, few professionals have the experience or knowledge to determine the value of intellectual properties. For this reason, the accounting profession has traditionally been very conservative in the valuation of intellectual property.

For instance, Coca-Cola had a market value of \$145,195 million in 1999 when its book value was only \$19,145 million and Microsoft has a market value of \$535 billion in 1998 when its book value was only \$37.4 billion. Although intellectual properties cannot completely account for this large difference, they likely account for a substantial share of it.

¹ M.Simensky, *The New Role of Intellectual Property in Commercial Transactions*, Licensing Economics Review, v. 2, No. 8 (May 1982)

Valuation techniques will improve with practice. As intellectual properties continue to take centre stage, more professionals will acquire the experience and knowledge necessary to put a fair market value on these properties.

However, it is not simply an accounting exercise. The second reason for uncertainty in the valuation of intellectual property is legal in nature. Unlike more familiar forms of property, (1) each intellectual property is wholly unique; (2) its value that can fluctuate dramatically; (3) it may be “lost” or “destroyed”; (4) it may be subject to lawful “trespasses” on its monopoly; and (5) it usually cannot be insured.

For instance, all registered intellectual properties are subject to expungement for invalidity on various grounds: (1) trademarks can be expunged for non-use; (2) patents and industrial designs can be expunged if released to the public more than one year prior to filing; and (3) copyrights can be expunged in circumstances where the author is improperly identified as the first owner. Unless “famous”, trademark monopolies are restricted to the class of products and services with which they have been used in the past. Copyright does not protect ideas and is subject to “fair use” by consumers. Patents can be rendered obsolete at any time by a new invention. Trade secrets can be independently discovered by others.

Most of the legal uncertainties in the valuation process are inherent to the nature of the intellectual property in question. In other words, these uncertainties are not likely to be reduced by legislative change. We simply have to learn to account for them when improving our valuation techniques.

The perfection of security interests in intellectual property also remains surprisingly uncertain

today. There are three reasons for this. First, there is no method stipulated by law for the perfection of security interests in intellectual property. Second, intellectual properties and the associated registers are, generally speaking, governed by federal law. Third, property rights and the associated registers (ie. the PPSA) are governed by provincial law. Although the provincial registers are more practical and efficient in most ways, they may prove ineffective where they conflict with a federal register given the “doctrine of paramountcy”. This legal doctrine gives federal law precedence over provincial law where they govern the same subject matter.

The federal registers are profoundly unreliable and difficult to search. Valid trademarks and copyright interests may exist without registration. Although security agreements are accepted for recordal on all federal registers, it is not mandatory. Each intellectual property is recorded in a separate record so security agreements must be recorded against each individual property (requiring the payment of multiple fees). Even the ownership particulars on the registers can be months out of date due to processing delays or years out of date where the new owner simply fails to file the assignment.

The provincial registers have their own potential pitfalls. For instance, it apparently remains an open question in some Canadian jurisdictions as to whether some forms of intellectual property qualify as “property” at all. This may include domain names, confidential information and licenses. If not considered “property” for the purpose of these registers, any PPSA registration will presumably be invalid.

Although the federal government has enacted a federal scheme for the perfection of security interests in marine properties where similar federal/provincial conflicts can arise², it has not yet enacted similar legislation for intellectual

properties despite calls for such reform.³ In other words, there is a legal vacuum. As a result, any party seeking to secure an interest in intellectual property faces an unfortunate and wholly unnecessary amount of legal uncertainty.

The standard legal advice is sometimes called the “belts and suspenders” approach. Where feasible, parties are advised to register their security interests on both the federal and the provincial registers in all the relevant jurisdictions. For some intellectual properties, this may include other countries and require the assistance of foreign counsel. Of course, the “belts and suspenders” approach is often expensive and time-consuming.

If cutting corners to save costs, the nature of the intellectual property may determine the least uncertain approach. For instance, recordal on the federal copyright register may be recommended where copyright has been registered. However, if copyright has not been registered, a PPSA registration may be sufficient and, practically speaking, the only means of perfecting the security interest.

To counteract all this uncertainty, some recommend that the security agreements include conditional assignments. Others recommend the creditor simply take an assignment at the outset and grant the debtor a right of redemption. However, debtors may resist such measures for business reasons. Such measures may also endanger the validity of some intellectual properties (especially trademarks). Still others recommend instead that security agreements include broad irrevocable powers of attorney to assist in the enforcement of any security interests against intellectual property.

The present uncertainties in the perfection of security interests in intellectual property are an unfortunate obstacle to economic growth in the

² *Canada Shipping Act, 2001* (2001, c. 26)

³ *Leveraging Knowledge Assets: Reducing Uncertainty for Security Interests in Intellectual Property*, Law Commission of Canada, 2004.

information age. They are not unique to Canada. This is also a vexing issue in the United States as a result of their own division of powers between federal and state governments.⁴ And it is being actively considered by various international organizations, including a Working Group of the United Nations⁵ and the International Trademark Association.⁶

Nevertheless, legislative change seems unlikely to happen any time soon. In the meantime, the best course of action is to ensure that the parties assemble a team of competent professional advisors to reduce the risks.

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⁴ Scott Lebson, *Security Interests in Intellectual Property in the United States: Are they Really Secure?*, Ladas & Perry LLP, New York

⁵ United Nations Commission on International Trade Law: Working Group VI (Security Interests) which is considering this issue in the context of preparing a *Draft Legislative Guide on Secured Transactions*

⁶ On March 21, 2007, the International Trademark Association adopted a resolution listing harmonization recommendations regarding the recordal of security interests in trademarks