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Review

Commercial & Dispute Resolution



Taking Security Over Intellectual Property

Introduction

Intellectual property rights ("IPR") will represent a material part of the value of some of the companies that lenders lend to. To put itself in the best possible position, a lender must accordingly understand:-

- What IPR exists
- What value they have
- How to spot them and the questions to ask about them
- What risks relate to them and how should they be dealt with

What Are Intellectual Property Rights?

The most common types of IPR are:-

- **Patents** – these give the holder a statutory monopoly of up to 20 years for a broad range of new inventions, new products and new industrial processes.
- **Trade marks** – brands can be protected by registration at various trade mark offices. Registration gives the owner of the mark a 10 year monopoly in relation to the commercial use of the mark for goods or services which the mark is registered for.
- **Copyright** – protects a broad range of original works from being copied, covering everything from music, software, written items (such as books and instruction manuals), films, photographs and TV and radio broadcasts.
- **Rights In Designs** – two or three dimensional works, such as the design of a new wallpaper, a new kettle or a car body part can be protected from copying. Designs can be protected for various different periods ranging from 3 to 25 years.

What Value Lies in IPR

A lender will be interested in IPR used in its borrowers' businesses because:-

IPRs will represent a material part of the value of some companies that lenders lend to

- While the borrower is trading, the lender will not want third parties to have any rights, which could be used to prevent its borrower from carrying out profit generating business operations.
- In an enforcement situation, third party rights affecting the IPR could adversely affect the lender's chosen enforcement route and its control over the assets subject to its security. In addition, such rights could materially reduce the value of the lender's security, as it may not be possible for an administrator, liquidator or receiver to realise assets affected by, or subject to, such IPR.
- They can provide a further strand of security for the lender if they have a free-standing market value, such that they could be sold alone, without the other elements of the borrower's business.

Not all IPR will have a ready market and realisable value. Every borrower's business will be different, but for all of them a lender should seek to understand how the value/profit in the business is generated and how the borrower's IPR relate to that value/profit generation. There is no substitute for a proper understanding of the borrower's business but a few rules of thumb can be stated.

IPR with real value tend to have one or more of the following characteristics:-

- Others could buy them from the owner and use them to create value. The copyright in a music back catalogue, a well-known clothing brand, the design of a carpet, a pharmaceutical patent or the confidential details of a process to make a new product are all things that competitors in the relevant markets may be able to plug into their existing businesses and use, thus giving the IPR a ready market.
- They protect things that are easy/profitable to copy but expensive or difficult to create. An improved battery or new video game, once developed, may be easy to copy but they may be very expensive, difficult or time-consuming to actually create.
- They protect a process that adds a lot of value. Pharmaceutical inventions can enable cheap commodity chemicals to be turned into an end product, which may have a market worth hundreds of millions of pounds a year. The main thing that stops others from making the same drug after a successful launch is the patent.
- They represent a real barrier to competition or protect a hard to acquire market position/goodwill. Products and services sold under premium brands or protected by patents can sell at a premium to less well-known brands because they have built up substantial goodwill in the minds of their consumers. That goodwill represents a partial barrier to product substitution.
- They embody a very substantial investment. Microsoft's Windows operating system and related applications have cost billions of dollars to develop. That investment is protected by copyright, trade marks and patents.
- They relate to unique features of products or services for which there is or could be a mass market. A modern home printer is now sold for a very low margin as the manufacturer expects to make a lot more money selling the ink cartridges for it. Each such cartridge is a special shape and contains some electronics (both features protected by IPR) which can make it hard to substitute other non-branded cartridges for it.
- IP that relates to how a company is run. Very often well run businesses will have developed a large amount of process and management know-how that enables them to be run efficiently. Such systems and procedures will be protected by "Operations IPR" such as copyright in staff handbooks, bespoke payroll, EPOS and other software systems etc. Operations IPR are often so bespoke and

IPRs with real value tend to have some specific characteristics

borrower specific that, unless they are sold with the borrower's business as a going concern, then they will by themselves have no ready market at all. However it would be a potentially serious mistake to conclude that such "Operations IPR" does not have any value, as without them the borrower's business cannot be lawfully operated.

How To Spot IPR And The Questions To Ask About Them

Enquires of Management

As part of its borrower due diligence, the lender should specifically ask the borrower's management:-

1. How much money the company has spent on R&D in the last few years? Significant R&D spend should have led to the creation of some IPR.
2. What IPR are used in the borrower's business?
3. Who owns the IPR?
4. Do the shareholders/directors of the borrower, any connected person or any other members of the borrower's group own any IPR which are used in the borrower's business?
5. Under what arrangements (licences etc) does the borrower use IPR that are not owned by the borrower? Copies of any relevant licences should be obtained and reviewed.
6. Have any licences, charges, mortgages, options or other third party interests been created in relation to any of the IPR used in the borrower's business and owned by the borrower, the borrower's group, its shareholders or directors? If so copies of relevant agreements should be obtained and reviewed to see how they impact on the value of such IPR as security.
7. Does the borrower know of any challenges to the validity or ownership of its IPR or of any facts or matters which could support such challenges?
8. Have all maintenance and renewal fees been paid in relation to registered IPR?
9. Does the borrower know of any third party claims that the borrower's business infringes or has infringed third party IPR, or of any facts or matters which could support such claims?

The borrower (and in the case of high value transactions its key stakeholders) should give warranties in relation to the facts and matters that the above questions reveal. This should enable the lender to have a clear understanding of what the borrower's IPR position is.

Searches

The lender should back up what it is told by the borrower's management by conducting searches of the charges register at Companies House and the relevant patents registers, trade mark registers and registered design registers in relation to:-

- The borrower
- The borrower's shareholders and directors
- Other Group or connected companies

Such searches should identify not just the IPR owned by the above, but should also reveal details of any third party licences, charges etc that have been registered. Hammonds can assist with these searches, on a case by case basis, if required.

As part of its borrower due diligence the lender should ask the borrower some specific questions

The lender may also consider looking at the borrower's website and doing Google searches against the borrower, as such searches often reveal useful facts about the ownership of IPR used in the borrower's business.

Examples of IPR Risks And How To Deal With Them

The main IPR risks for a lender and how to deal with them are set out below:-

Risk 1: The Borrower Deals With Its IPR After Facilities Have Been Provided

The borrower may license, charge or assign its IPR to third parties after the facilities have been made available by the lender.

Solution

- The security documents should impose negative covenants on the borrower, backed up by further covenants from management or other key stakeholders that they will not sell, license, charge/mortgage or otherwise deal with the company's IPR, nor allow such things to happen.
- The lender should take a charge or mortgage of the relevant IPR wherever possible. A mortgage of IPR involves an outright assignment, usually with a licence back to the borrower so the borrower can continue to trade. A charge grants the lender a bundle of rights over the IPR in the event of borrower default – typically the right to sell the IPR.
- As well as the usual registration at Companies House within 21 days of creation, the lender should also ensure that those charges/mortgages are registered at the relevant IPR registries (the patents register, the trade marks register or the registered designs register). Only if charges and/or mortgages are registered at the relevant IPR registries will a third party who subsequently acquires rights over the IPR, take them subject to the lender's earlier registered rights.
- The lender should also register a "caveat" with the relevant IPR registry. This will ensure that notice be given to the lender of particular events concerning dealings with the IPR. Once notice has been received, the lender can make enquiry of its borrower to ascertain what is going on.

Risk 2: Key IPR Is Held Outside The Borrower

In this scenario on the borrower's insolvency, the third party owner asserts its rights over the IPR against the borrower thus materially reducing the value of the assets subject to the lender's security. If the borrower's business cannot be run without infringing third party IPR then purchasers will be put off and the price of it may plummet. In the worse case scenario the borrower's business will be unsaleable.

Solution

To minimise the risks of this happening, the lender should:-

- Conduct the enquiries of management and searches referred to above.
- Take warranties from key management or other stakeholders to the effect that the borrower owns all the IPR necessary to operate the borrower's business as a going concern.
- Impose covenants on the borrower that look to the future: i.e. which oblige the borrower and relevant others (directors and shareholders etc) to register new IPR capable of being used in the business (including improvements to the borrower's existing IPR and technology) in the name of the borrower. Such new IPR should also automatically fall within the scope of the Lender's pre-existing charges and mortgages.

The lender may also consider looking at the borrower's website and Google searches

- Particular care is needed where the borrower trades under a name, which is also used by other borrower group companies. On the borrower's insolvency, a purchaser of its business may require the right to continue to trade under the borrower's name, so as to hold on to its customers. If other borrower group companies continue to trade under similar names this could lead to confusion and conflicts down the line. The lender should deal with these issues in advance by, for example, requiring the borrower to obtain consents from the borrower group to any future transfer by the lender of the right to trade under the borrower's name.

Risk 3: The Borrower Does Not Renew Registered IPR Or Allows It To Be revoked

Patents have to be renewed annually, trade marks every ten years and registered designs every five years. If the rights are not renewed then they lapse and cease to have any effect in law.

The validity of registered IPR can also be successfully challenged by third parties in the courts or in the relevant IP registries. Such challenges can result in the revocation of the registered IPR with the effect that they cease to exist.

Solution

The solution is to impose covenants on the borrower to renew and defend the registered IPRs and to notify the lender of any facts or matters, which may impact on the value of the IPR as security, including challenges to its validity.

The caveat mentioned above can also be used to get early notice of a failure to renew a registered IPR. Such early notice is worth having because renewal fees can often be paid late, subject to payment of a supplemental fee, thus keeping the IPR registered.

Risk 4: IPR Registry Entry Is Not Conclusive

It is important that the lender appreciates the limitations on a search of registered IPR and guards against the risk of a prior owner of IPR purporting to transfer the same rights to different parties before registration of the borrower's ownership.

Solution

Whenever the borrower's key registered IPR have been subject to earlier transactions then a proper chain of title should be verified: this may require making enquiry of previous vendors of the IPR, in reliance on the borrower's further assurance clauses in the sale contract to him from such vendors.

FURTHER INFORMATION

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