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### COLLATERALIZATION OF INTELLECTUAL PROPERTY: ALCHEMY FOR TURNING INTANGIBLE ASSETS INTO GOLD

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#### *Abstract*

*Big companies over time have collateralized their IP, for different reasons may it be preventing bankruptcy or to finance R & D, but still collateralizing IP is a rare phenomenon and needs attention. Collateralization of intellectual property is highly beneficial for the corporates as it prevents company from becoming bankrupt on one hand and it extracts credit with nothing at stake, on the other. To prevent the interest of the Bankers as well as IP holders we need to amend the set of laws and regulations. Volatile nature of IP and issues such as overuse or negative publicity is resulting in constant reduction in its value and makes it very difficult to use IP as collateral. Not only big firms but also MSMEs will be the beneficiaries of the simplified and well-regulated process of collateralizing IP. We need to develop an environment where collateralization of IP becomes common phenomena; this will need IP holders such as MSMEs, start-ups and bankers to understand their respective roles in doing so. The paper discusses the nuts and bolts of IP collateralization. It goes on to explain the ways and means to convert IP into collateral, it briefly explicates on India's position and how collateralizing IP fits the bill when it comes to immediate funding with all other boons. The paper not only puts forth the impediments and disadvantages of collateralizing IP but also suggests some ideas to overcome the shortcomings. The intention behind the paper is to promote the use of intellectual property to extract credit which also strengthens the economy and call for innovations.*

#### **KEYWORDS**

*Collateralization, IP, MSMEs, IP exchange, Market, Volatile*

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## INTRODUCTION

Intellectual property is nothing but the packaged product of creation by a human mind. IP is protected by various laws, which mutates it into intangible assets. These intangible assets become capable of extracting credit, but it is very eminent that this IPs are ensconced and its value remains unharmed which makes collateralization of IP an ideal method for raising funds and should be put into practice. This very conjecture sets up the footing of the Knowledge-based economy and comes to rescue for micro enterprises in need of money. MSMEs and start-ups possess IPs but lack tangible assets and business needs cash inflow to prosper. For MSME's using IP to get a loan is the most viable option. The safer way it is to raise funds, the less it is exploited for multiple reasons.<sup>3</sup>

Let us take the Indian scenario, MSMEs are in desperate need of financial assistance, as the International Finance Corporation's 2018 report says; "overall demand for both debt and equity finance by MSMEs is estimated to be INR 87.7 trillion which comprises INR 69.3 trillion of debt demand and INR 18.4 trillion of equity demand."<sup>4</sup> India has the third-largest economic market for MSMEs and Start-ups in the IP-intensive sector such as Information technology and bio-pharmaceuticals (Drugs).<sup>5</sup>

Pledging IP is the befitting way to meet this debt by the MSMEs. The company's tangible assets are already in debt, and consequently they have no other option but to get financial assistance through IP-backed loans. Withal there is a possibility that pledging IP as collateral can in lieu increase the debt, if in future the company, unfortunately, does not earn profit and is not able to repay the loan and the value of their IP dwindles. The paper aims to counter such conundrums and lays down effective solutions. There is only one fly in the ointment that is 'risk'. It is risky for the lenders to lend IP backed loans as in case of default liquidating IP may not repay the loan owing to its volatile nature. It's risky for the IP holder as in some cases investors tend to extract so much that it leads to exhaustion. The simple solution is to fabricate a risk proof-

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<sup>3</sup> *MSME Schemes*, GOVERNMENT OF INDIA, 1, 20 (2015), [https://msme.gov.in/sites/default/files/MSME\\_Schemes\\_English\\_0.pdf](https://msme.gov.in/sites/default/files/MSME_Schemes_English_0.pdf).

<sup>4</sup> *Financing India's MSMEs Estimation of Debt Requirement of MSMEs in India*, INTERNATIONAL FINANCE CORPORATION I 1, 09 (2019), <https://www.ifc.org/wps/wcm/connect/def9d09d-68ad-4e54-b9b7614c143735fb/Financing+India%E2%80%99s+MSMEs+Estimation+of+Debt+Requirement+of+MSMEs+in+India.pdf?MOD=AJPERES&CVID=my3Cmzl>.

<sup>5</sup> *MSME Industry in India*, INDIA BRAND EQUITY FOUNDATION (Jul, 9 2021), <https://www.ibef.org/industry/msme.aspx>.

model of IP collateralization which protects all the parties in the contract and this is what the paper aims at.<sup>6</sup>

Back in the 1800s Thomas Edison collateralized its patented electric bulb, to raise funds to start a new company called General electric company<sup>7</sup> but now the whole world is on the verge of a revolution driven by the force of Intellectual Property (IP).<sup>8</sup> The environment relating to the regulation of IPR is evolving around the world, and various government initiatives to provide momentum to IP-backed financing are in progress. However, some economies like that of Singapore created a revolutionary global hub plan with the regulatory surrounding and robust infrastructure for IP backed financing.<sup>9</sup> The paper gathers information on such commendable initiatives taken by the organizations and countries all over the world and discusses real life stories of how IP collateralization has saved and helped companies to sustain and augment.

## **TYPES OF IP BACKED LOANS AND THEIR MODUS OPERANDI**

IP may be treated as an asset to raise the credit, but unlike other assets, IP has its attributes (IP's value is volatile, lacks a secondary market and needs much expertise in transactions); hence the procedure may sometimes become cumbersome.

**Direct Collateral**-The simplest form of pledging IP is by treating it as direct collateral. The procedure is simple; like immovable property, the lender can secure his loan in case of default or insolvency of the debtor through licensing agreements. The lender may sell the rights vested in IP and collect revenues. Being the most straightforward method for the lenders, it is risky, too, as the value of IP is volatile<sup>10</sup>.

**Securitization**-The aforementioned risk can be eliminated through securitization, wherein IP or rights in the projected revenues are placed in the hands of special purpose vehicles (SPV), which issues securities against IP in the capital market. For instance, company 'X' borrowed a

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<sup>6</sup> *New Approaches to SME and Entrepreneurship Financing: Broadening the Range of Instruments*, OECD 1, 20 (2015), <https://www.oecd.org/cfe/smes/New-Approaches-SME-full-report.pdf>.

<sup>7</sup> Brian W. Jacobs, *Using Intellectual Property to Secure Financing after the Worst Financial Crisis since the Great Depression*, 15 Marq. IPL. Rev. 450, 450 (2013), <https://scholarship.law.marquette.edu/cgi/viewcontent.cgi?article=1178&context=iplr>.

<sup>8</sup> Stephen Ezell, Nigel Cory, *The Way Forward for Intellectual Property Internationally*, ITIF (Apr. 25 2019), <https://itif.org/publications/2019/04/25/way-forward-intellectual-property-internationally>.

<sup>9</sup> Giovanni Sapere, *Singapore's 10-Year Plan for IP Growth*, THE PATENT (June 22, 2021), <https://www.thepatent.news/2021/06/22/singapores-10-year-plan-for-ip-growth/>.

<sup>10</sup> Varun Gupta, Arvind Thakur, *IP-Backed Financing: Using Intellectual Property as Collateral*, CIIIPR, 1, 6 (2019), <https://ciiipr.in/pdf/CII-Duff-&-Phelps-Report-on-Using-IP-as-Collateral-2019.pdf>.

loan from the bank against its trademark. The bank will place rights vested in this trademark with SPV. SPV will raise shares for the trademark, henceforth securing the bank's loan (through the selling of shares). If the trademark value falls, the burden of loss will be on shareholders and not the bank. Securitization of the trademark of Domino's pizza chain<sup>11</sup> and that of HIV drug patent by Yale University<sup>12</sup> are two examples of how giants choose to raise funds.

**Sale-and-Leaseback Transactions**-Then there is a sale-and-leaseback transaction wherein the IP owner sells the IP to the lender or investor in exchange for immediate funding but simultaneously has the license to use the IP in return for specified royalty payments made to the buyer for a specific period. After the end of the period, the borrower can buy back IP at a predefined price. In 2010 Avgo technologies entered into a sale-and-leaseback transaction with Deutsche Bank and mortgaged around 2000 patents.<sup>13</sup>

**Venture Debt**-This financial model has both loan and equity components. In this arrangement, the company seeking investment receives capital in the form of a loan that it pledges to repay with interest. At the same time, the company offers warrants for equity in the company, which the lender acquires. IP is a valuable asset in these transactions, but the loan is generally secured by a blanket lien, which is a claim on all of the firm's assets in the event of failure to make repayment.

## INDIA'S STAND ON PLEDGING IP

India has nearly 6.3 crores of MSMEs at present and approximately 23.4 % of them have registered patents.<sup>14</sup> The pharmaceutical sector has the maximum number of patents.<sup>15</sup> MSMEs do understand the importance of patent and trademark, but their comprehension of 'brand' and the significance of defending it with the right of trademarks and transforming IPs into an easily transferable non-tangible asset can often be seen in dearth.<sup>16</sup>

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<sup>11</sup> Tahir M.Nisar, Intellectual Property Securitization and Growth Capital in Retail Franchising, SCIENCE DIRECT (Sep. 1, 2011), <https://www.sciencedirect.com/science/article/abs/pii/S0022435910000953>.

<sup>12</sup> Mei-Hsin Wang, *Legislation Study on Patent Securitization*, 11 Eng. L. Rev. 66, 75 (2014), [https://www.ipaj.org/english\\_journal/pdf/11-2\\_Wang.pdf](https://www.ipaj.org/english_journal/pdf/11-2_Wang.pdf).

<sup>13</sup> *IP Monetization – 'Sale and Leaseback' Option*, INTRICATE RESEARCH (Jan. 27, 2020), <https://www.intricate-research.com/ip-sale-and-leaseback.html>.

<sup>14</sup> *MSME Industry in India*, INDIA BRAND EQUITY FOUNDATION (Jul, 9 2021), <https://www.ibef.org/industry/msme.aspx>.

<sup>15</sup> *National Study on Intellectual Property and Small and Medium Sized Enterprises*, WIPO, 1, 2 (2012), [https://www.wipo.int/edocs/pubdocs/en/wipo\\_natstudy\\_sme\\_india.pdf](https://www.wipo.int/edocs/pubdocs/en/wipo_natstudy_sme_india.pdf).

<sup>16</sup> *Making intellectual property work for business A handbook for chambers of commerce and business associations setting up intellectual property services*, WIPO, 1, 1 (2011), [https://www.wipo.int/edocs/pubdocs/en/intproperty/956/wipo\\_pub\\_956.pdf](https://www.wipo.int/edocs/pubdocs/en/intproperty/956/wipo_pub_956.pdf).

IPR policy released in 2016 by the government depicts the intention of India to endorse the commercialization<sup>17</sup> of IP, especially through securitization. The Indian legal framework pertaining to IPR complies with the WTO's agreement on TRIPS (Trade-Related Aspects of Intellectual Property Rights).<sup>18</sup> This policy also suggests an IP exchange platform to bring together both IP owners and investors to make the process painless. Laws that legalize collateralization of IPs are as follows-

- **SARFAESI Act, 2002**<sup>19</sup> - In India the enforcement of security interest is guided by SARFAESI Act, 2002. Section 2 (1) (zf) of the said Act defines a security interest as the right, title, or any kinds of interest of the lender in the property by the virtue of hypothecation, mortgage, assignment. Further, section 2(t) of the SARFAESI Act defines property to include intangible assets, being know-how, patent, copyright, trademark, etc., thus allowing the owner to use IP as collateral for raising funds.
- **Companies Act, 2013**<sup>20</sup> – Schedule III of Companies Act, 2013 (j) provides the list of intangible assets and section 77 of chapter VI “allows a company to create a charge on its property or asset”.

Statutes on different intellectual properties also mention using IP as an asset to extract credit.

- **The Copyright Act, 1957**<sup>21</sup> – Section 18 of The Copyright Act, 1957 allows the owner for the assignment of the copyright subjected to certain conditions.
- **The Indian Patents Act, 1970**<sup>22</sup> – Section 68 of The Indian Patents Act, 1970 and,
- **The Design Act, 2000**<sup>23</sup> -permits patents and designs to be assigned or kept as mortgage.
- **Trademark Act, 1999**<sup>24</sup> - Section 38 and section 39 of The Trademark Act, 1999 allows assignability and transmissibility of registered and unregistered trademarks respectively.

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<sup>17</sup> All you need to know about the new IPR Policy, THE HINDU (May 14, 2016), <https://www.thehindu.com/business/all-you-need-to-know-about-the-intellectual-property-rights-policy/article8600530.ece>.

<sup>18</sup> Dr. Manisha Shridhar, *Trade Related Aspects of Intellectual Property Rights (TRIPS)*, INDIAN INSTITUTE OF FOREIGN TRADE 1, 11 (2010), <http://wtocentre.iift.ac.in/FAQ/english/TRIPS.pdf>.

<sup>19</sup> The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, No. 54.

<sup>20</sup> Companies Act, 2013, No. 18.

<sup>21</sup> The Copyright Act, 1957, No. 14.

<sup>22</sup> The Indian Patents Act, 1970, No. 39.

<sup>23</sup> The Design Act, 2000, No. 16.

<sup>24</sup> Trademark Act, 1999, No. 47.

Still using IP as collateral is difficult in India owing to lack of a proper mechanism. As aforementioned laws related to IP and those governing the securitization of IP are uncertain.<sup>25</sup> The initial and most important step to pledge IP as collateral is to do a ‘proper evaluation’.<sup>26</sup> Further, Intellectual property can be transferred to the lender through a contract, that is, a written agreement is mandatory for the owner to transfer rights vested in IP to the lender. Registration of the transfer is a prerequisite for claiming the title in IP. A mortgagee or a licensee whosoever it is needs to inform the registrar or the controller in a prescribed manner about the transaction. The controller or the registrar on the biases of proof and the receipt of such application will register the title; however, the Copyright Act is silent on registration of the transfer of title.<sup>27</sup>

There is a certain process that needs to be followed to create security over an IP, as described below –

- Stamp Duty – According to the stamp Act, a charge has to be paid on documents which differ from state to state.
- As mentioned above the debtor needs to inform the Registrar of the company through filing a form for the purpose to record the security created with the certificate of the charge.
- A charge must be filed under CERSAI (Central Registry of Securitization Asset Reconstruction and Security Interest of India) over the IP. The person/entity in whose account the security interest has been formed must complete the registration.
- Filing with the IPR office – The security creation and the assignments of IP need to be compulsorily filed and registered respectively, at the concerned IP office. This process does not apply to copyrights.
- Release Deeds: After the loan has been successfully repaid, release deeds must be performed. To terminate the security interest formed over the IP, the release deeds must be submitted to the concerned IP office.<sup>28</sup>

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<sup>25</sup>Rachi Gupta, *India: Intellectual Property as Security*, MONDAQ (July 8, 2020), <https://www.mondaq.com/india/trade-secrets/962878/intellectual-property-as-security>.

<sup>26</sup>*IP as Collateral*, IIPRD (Feb. 23, 2021, 5:24 PM), <https://www.iiprd.com/ip-as-collateral/>.

<sup>27</sup>Nandan Pendsey, Kirti Balasubramaniam, Aparajita Lath, *Security interest over Intellectual Property Rights*, LEXOLOGY (Feb. 26, 2018), <https://www.lexology.com/library/detail.aspx?g=835049a6-94ea-4832-a68d-366b86c40440>.

<sup>28</sup>*IP as Collateral*, IIPRD (Feb. 23, 2021, 5:24 PM), <https://www.iiprd.com/ip-as-collateral/>.

The Federation of Indian Chambers of Commerce and Industry (FICCI) and the Federation of Micro, Small and Medium Enterprises (FISME) have been the major drivers of commercial activities interface with IP. Both organizations have started numerous IP programs with assistance from the Ministry of MSME. They have also established IP facilitation centers in major cities such as Delhi, Hyderabad, and Bangalore. Their main objectives are to create an IP valuation to realize the worth of IP and to establish a mechanism to sell it. British High commission through prosperity fund is assisting this organization to create an experimental site for IP marketplace (IP Exchange) at [www.IPRexchange.in](http://www.IPRexchange.in). Also, the ministry of science and technology's attempt to establish an IP Exchange in India, similar to those in Hong Kong and the United Kingdom, is remarkable.<sup>29</sup>

India is continuously striving to make a robust IPR system that can provide impetus to commercialize the IPRs. Efforts are evident through schemes such as digital India, Make in India, Start-up India. Through which the government tries to help MSMEs and start-ups by expediting reviews for patent filing, reducing filing fees and technical assistance.<sup>30</sup> Amazon- an e-commerce company recently unveiled its IP accelerator program in India which will offer protection to IP of several sellers all over the country by granting legal services and by preventing infringement which is otherwise not affordable. This initiative is aimed at protecting IPs of MSMEs else ways they may have a hard time surviving in the market.<sup>31</sup>

## **COLLATERALIZATION OF IP- AN APT WAY TO RAISE FUNDS**

Genesis of intellectual property or expansion of business and collateralization of IP goes hand in hand. Firms continuously strive for innovation, like creating intellectual property. MSMEs look forward to expanding their business. Leveraging such innovations brings funds to companies that will again be invested in Research and development, leading to the formation of new IPs and in the same way, helps small businesses to grow. This provides a competitive edge in the market and helps companies raise a lot of capital.<sup>32</sup>

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<sup>29</sup>Shrimant Singh, *India: Coming Soon: Intellectual Property Exchange in India*, MONDAQ (Aug. 3, 2017), <https://www.mondaq.com/india/trademark/616424/coming-soon-intellectual-property-exchange-in-india>.

<sup>30</sup>Ruchika Chitravanshi, National policy suggests use of intellectual property rights as collateral to raise funds, *THE ECONOMIC TIMES* (Dec. 16, 2015), <https://economictimes.indiatimes.com/news/economy/policy/national-policy-suggests-use-of-intellectual-property-rights-as-collateral-to-raise-funds/articleshow/50194124.cms>.

<sup>31</sup>Animesh Singh, Amazon Offers Intellectual Property Protection for Businesses in India, *NDTV PROFIT* (July 4, 2021), <https://www.ndtv.com/business/amazon-launches-intellectual-property-protection-for-businesses-in-india-2479020>.

<sup>32</sup>Amit Aggarwal, *Relevance of intellectual property for business*, *THE ECONOMIC TIMES* (Oct. 28, 2015), <https://economictimes.indiatimes.com/small-biz/legal/relevance-of-intellectual-property-for-business/articleshow/49563911.cms>.



In the case of a well-run business, there is always the possibility of increasing the value of IP assets over time and a reduction in the value of tangible products. IP assets allow lenders to lend on the biases of performance of IP rather than the creditworthiness of borrowers. This further enables more lending at certain times especially when existing good customers want to borrow more than established asset-lending ratios will allow. The value of IP may allow lenders to lend more than the fixed ratio, with security.<sup>33</sup>

IP collateralization is an essential tool for reducing credit rationing (the situation where the lender limits the credit to borrowers)<sup>34</sup>. MSMEs are most likely to be eliminated by the bankers when extending loans due to rationing. The major reason behind this is the common perception about MSMEs; “A common problem in MSMEs is that the proportion of fixed assets to total assets is too low. The core competitiveness of MSMEs is often manifested in intangible assets such as intellectual property right-sand brand value, thus lack of valid and collateralizable fixed assets”<sup>35</sup> collateralizing such manifestation of intangible assets will directly counter the problem of lack of collateralizable fixed assets. The credit rationing problem is most often faced by technology-based firms as all their investments are turned into IP, but a risk-proof model for collateralizing IP is needed to curb the problem.<sup>36</sup>

Most IP assets do not demand regular expenditure, unlike tangible assets that contribute to leverage enhancement, which not only raise funds and credit rating, but also the firm's ability to develop and thrive.<sup>37</sup>

When compared to standard tangible asset securitization, the interest rate on IP securitization is significantly cheaper in the sense that interest rates are low. It aids the originator in raising cash at a lower cost than tangible assets. Notwithstanding the interest rates that lenders demand on the securities are determined by the IP asset's quality and credit rating.<sup>38</sup>

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<sup>33</sup> K.R. Pradeep, *INTELLECTUAL PROPERTY RIGHTS: A CASE FOR MONETIZATION*, CIIPR, 1, 7 (2019), <https://ciiipr.in/pdf/CII-Singh-&-Singh-Report-IPR-A-Case-for-Monetization-2019.pdf>.

<sup>34</sup> *Definition of 'Rationing'*, THE ECONOMIC TIMES (JUL. 20, 2021), <https://economictimes.indiatimes.com/definition/rationing>.

<sup>35</sup> Yuhuan Jin, Zhang Sheng, *Credit Rationing in Small and Micro Enterprises: A Theoretical Analysis*, RESEARCHGATE, 1, 4 (2019), [https://www.researchgate.net/publication/331500504\\_Credit\\_Rationing\\_in\\_Small\\_and\\_Micro\\_Enterprises\\_A\\_Theoretical\\_Analysis](https://www.researchgate.net/publication/331500504_Credit_Rationing_in_Small_and_Micro_Enterprises_A_Theoretical_Analysis).

<sup>36</sup> *Id.*

<sup>37</sup> John P. Ogier, *Intellectual property, finance and economic development*, WIPO (Feb., 2016), [https://www.wipo.int/wipo\\_magazine/en/2016/01/article\\_0002.html](https://www.wipo.int/wipo_magazine/en/2016/01/article_0002.html).

<sup>38</sup> William J. Kramer, Chirag B. Patel, *Securisation of intellectual property assets in the US market*, IPO, 1, 4 (2006), [https://ipo.org/wp-content/uploads/2013/04/Securisation\\_of\\_IP\\_in\\_the\\_US.pdf](https://ipo.org/wp-content/uploads/2013/04/Securisation_of_IP_in_the_US.pdf).



IP collateralization enables the lenders in risk diversification and risk-sharing. This facility is generally not available for conventional forms of loans. There is a whole setup of risk-sharing tools and techniques (discussed at the later stage) which not only protects lenders from the risk of turning loans into non-performing assets but also takes away the burden to liquidate the collateral in case of default.

Defining IP assets as part of a lending agreement helps the bank to safeguard its interest by putting them in a much stronger position with an administrator or insolvency practitioner. Most importantly it is exempted from the bankruptcy proceedings since the IP asset is transferred from the originator to lender.<sup>39</sup>

In the leading case of *Canara Bank v. N.G. Subbaraya Setty and Ors*<sup>40</sup> the Canara Bank extended loan to N.G. Subbaraya Setty, owner of the trademark 'EENADU'. An assignment deed was executed through which the bank used the trademark EENADU for the repayment of loan, but only for several months, after which they annulled the deed citing the reason that the bank could not engage in any activity other than banking and could not be an assignee of a trademark, as per the Banking regulation Act, 1949<sup>41</sup>. Herein Setty claimed for reimbursement, but the bank contended that the deed was void. The court adjudicated that, Setty had not pledged his trademark, EENADU, while seeking loan from the bank, and so the trademark could not be considered a security held by the bank within the meaning of Section 6 of the Banking Regulation Act, 1949. This depicts the importance of defining IP assets in the lending agreement as collateral, which is beneficial for not only lenders but also for borrowers.

IP can attract loans even in times of recession. It is true that recession hits hard to all sectors of the economy and IP is no exception, no matter which part of the hull is holed the whole ship sinks but IP is the last part of the ship to get submerged. This buoyancy of IP is because it is long-lived and potentially perpetual as it is one of its kind, for instance take trademarks, they hold some value and it is still maintained and protected by the laws even at tough times.<sup>42</sup>

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<sup>39</sup> K.R. Pradeep, *supra* note. 31.

<sup>40</sup> *Canara Bank v. N.G. Subbaraya Setty and Ors*, AIR 2018 SC 3395.

<sup>41</sup> Banking regulation Act, 1949, No. 10.

<sup>42</sup> Brian W. Jacobs, *Using Intellectual Property to Secure Financing after the Worst Financial Crisis since the Great Depression*, 15 Marq. IP L. Rev. 450, 461 (2013), <https://scholarship.law.marquette.edu/cgi/viewcontent.cgi?article=1178&context=iplr>.

## IMPEDIMENTS AND CHALLENGES IN STRUCTURING COLLATERALIZATION OF IP

Using IP as an asset is a recent phenomenon and is still in its developing stage. Though there are an elaborate set of rules for governing collateralization of IP, yet there exist some downsides and loopholes in the structure.

As the ownership of the IP is fractionalized it gives rise to competing claimants. Ensuring that the lender gets the top priority among all claimants and can use collateral to recover the loan is a hectic task and needs due diligence.<sup>43</sup> At times the licensor retains the right to cancel the license, in such cases; it becomes difficult for the lender to use royalty as collateral. The debtor licensee also needs to pay the part of royalty to the licensor which undermines the use of IP as collateral.<sup>44</sup>

The foremost stumbling block for the collateralization of IP is the valuation of IP. Many factors of dynamic nature are engaged in determining the value of IP, besides there is no specific method to do the same. Moreover, determining the current value is still possible but whether its value will remain constant in the near future is variable.<sup>45</sup> In the year 1997 David Bowie securitized 25 albums to raise \$55 million<sup>46</sup>. Later Nickolas Ashford and Valerie Simpson raised \$25 million against the copyright of 247 songs. But later with the advent of online music sharing services, the value of recordings diminished. The authorized but unconditional sale of IP, especially in the case of physical embodiments makes it impossible for rights holders to control the later uses; this is known as exhaustion, which is consequential to intangibility of IP<sup>47</sup>, which thereby reduces the value of IP to nil.

Another example of collateral (IP) with zero value is a company owned by the king of good times. Vijay Mallya offered the trademark of kingfisher airline as collateral to SBI for a loan

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<sup>43</sup> Dashpuntsag Erdenechimeg, *Using Intellectual Property as Collateral: An International Experience and a Mongolian Perspective*, 1, 6 (2016), <https://www.itcilo.org/sites/default/files/inline-files/Erdenechimeg.pdf>.

<sup>44</sup> *Sample Licensing Clauses*, GOVERNMENT OF CANADA (May 1, 2019), <https://www.canada.ca/en/heritage-information-network/services/intellectual-property-copyright/guide-developing-digital-licensing-agreement-strategy/sample-licensing-clauses.html>.

<sup>45</sup> Dashpuntsag Erdenechimeg, *Using Intellectual Property as Collateral: An International Experience and a Mongolian Perspective*, ITCILO, 1, 11 (2016), <https://www.itcilo.org/sites/default/files/inline-files/Erdenechimeg.pdf>.

<sup>46</sup> Ethan Wolff-Mann, *Bowie Bonds: How David Bowie Securitized His Royalties and Predicted the Future*, MONEY (Jan. 11, 2016), <https://money.com/david-bowie-bond-royalties-securitized/>.

<sup>47</sup> *Interface BETWEEN Exhaustion of Intellectual Property Rights and Competition Law*, WIPO, 1, 3 (2011), [https://www.wipo.int/edocs/mdocs/mdocs/en/cdip\\_8/cdip\\_8\\_inf\\_5\\_rev.doc](https://www.wipo.int/edocs/mdocs/mdocs/en/cdip_8/cdip_8_inf_5_rev.doc).

of 2000 crore.<sup>48</sup> Owing to default, the bank arranged an auction to liquidate the collateral, but it was unsuccessful due to its bad reputation. A Fitch rating on Toys R Company shows that the part of loan secured by real estate was 90% recoverable whereas part of loan secured by IP was 10 percent recoverable all because of the advent of online shopping sites<sup>49</sup>.

It is very easy to calculate the value of the real estate and its prospects, the reason being the availability of secondary market, the availability of buyers and sellers easily determines the value of the product but as there is no such market for IP, it gives rise to all other problems such as valuation of IP, liquidating the IP, regulating its use. The unavailability of a formalized market gives rise to uncertainty; this makes liquidating IP a chaotic and time-consuming task.<sup>50</sup>

It is not only the lender who is vulnerable but it may also sometimes lead the owner to losses, for instance, securitization of IP may lead to its exploitation, investors/lenders may try to extract as much as possible in a given time. This is largely attributed to the higher risks like infringement, technological obsolescence, and unauthorized use of intangible assets over tangible assets. Also, bilateral transactions relating to IP are costly as it needs due diligence of the lender and fees of hiring an attorney.<sup>51</sup>

## **RECOMMENDATIONS- BUILDING A RISK-PROOF MODEL**

Facilitating the collateralization process needs to be done along three policy guidelines, them being: set up and support an IP market, sharing risk in the process and outspread awareness and trust. This could be done by three key players of the process. First is the Government, second are lenders and third are IP holders. If these players play their roles well it will automatically create an environment of using IP for extracting credit, and will curb a lot of problems such as information asymmetry.<sup>52</sup>

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<sup>48</sup> Pritha Mitra Dasgupta, Maulik Vyas, Kingfisher Trademark High on Brand Recall but Low on Brand Valuation, *The Economic Times* (Mar. 12, 2016), <https://economictimes.indiatimes.com/news/company/corporate-trends/kingfisher-trademark-high-on-brand-recall-but-low-on-brand-valuation/articleshow/51366949.cms?from=mdr>.

<sup>49</sup> *Fitch Downgrades Toys 'R' Us' IDR to 'D'*, FITCHRATINGS (Sep., 2017, 05:49 PM), <https://www.fitchratings.com/research/corporate-finance/fitch-downgrades-toys-r-us-idr-to-d-19-09-2017>.

<sup>50</sup> *Final Report from the Expert Group on Intellectual Property Valuation Publications Office of the European Union*, EUROPEAN COMMISSION (2014), [http://ec.europa.eu/research/innovationunion/pdf/Expert\\_Group\\_Report\\_on\\_Intellectual\\_Property\\_Valuation\\_IP\\_web\\_2.pdf](http://ec.europa.eu/research/innovationunion/pdf/Expert_Group_Report_on_Intellectual_Property_Valuation_IP_web_2.pdf).

<sup>51</sup> Abhishek Kumar, *Intellectual Property as Collateral*, *ECONOMICS AND POLITICAL WEEKLY* (Aug. 1 2020) <https://www.epw.in/journal/2020/31/commentary/intellectual-property-collateral.html>.

<sup>52</sup> *ENQUIRIES INTO INTELLECTUAL PROPERTY'S ECONOMIC IMPACT*, 457, 459 (2015), <https://www.oecd.org/sti/ieconomy/Chapter9-KBC2-IP.pdf>.

## PLAN OF ACTION FOR THE GOVERNMENT

Major drawbacks in collateralization of IP, such as no standard way of valuation, costly transactions is because of absence of a secondary market, hence it is recommended to form an IP exchange. IP exchange is like a financial exchange developed through laboratory IP owners, corporate, and universities. IP Exchange will convert patent rights into standardized instruments called Unit License Rights (ULR). Then these ULR can be bought and sold on stock exchange but ULR grants one time right to use in a single product facing or certain number of units, for instance a patent contract on an IP exchange for wireless alarm system in cars may have ULR of 50,000 units, that means purchaser of the contract will be allowed to use such a system for 50,000 cars and not more. This will facilitate trade in IP in a much-regulated manner and it will prevent fraud. IP exchange will solve almost all the problems relating to transactions of IPs. India has exactly such an IP exchange which is known to be user friendly and multitasking.<sup>53</sup>

In 2007, the Danish Patent and Trademark Office launched the “IP Marketplace” ([www.ipmarketplace.org](http://www.ipmarketplace.org)) as an “online display window” for IPR holders to openly list their assets for sale or out-licensing.<sup>54</sup>

Conjointly there need to be some policy intervention when it comes to valuation of IP. As this forms the base for the lender's decision to lend. We have two exemplary works which could solve this problem. The EU proposes to form a centralized organization of experts which will engage in valuation of IP. This will not only standardize the valuation model but also reduce the cost such as that of lawyers or accountants, technology etc., and will become a one stop destination for valuation.<sup>55</sup> Singapore has also set up a centre with an accreditation centre.<sup>56</sup> Then we have a few countries such as Malaysia, Germany, and Italy which have official

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<sup>53</sup> Varun Gupta, *supra* note 10.

<sup>54</sup> *Driving Growth and Development for Companies*, DANISH PATENT AND TRADEMARK OFFICE, <http://old2.dkpto.org/ip-law--policy/national-ip-policy/ip-marketplace.aspx>.

<sup>55</sup> *Final Report from the Expert Group on Intellectual Property Valuation Publications Office of the European Union*, EUROPEAN COMMISSION (2014), [http://ec.europa.eu/research/innovationunion/pdf/Expert\\_Group\\_Report\\_on\\_Intellectual\\_Property\\_Valuation\\_IP\\_web\\_2.pdf](http://ec.europa.eu/research/innovationunion/pdf/Expert_Group_Report_on_Intellectual_Property_Valuation_IP_web_2.pdf).

<sup>56</sup> *Update to The Intellectual Property Hub Master Plan*, IPOS, 1, 16 (2017), [https://www.ipos.gov.sg/docs/default-source/about-ipos-doc/full-report\\_update-to-ip-hub-master-plan\\_final.pdf](https://www.ipos.gov.sg/docs/default-source/about-ipos-doc/full-report_update-to-ip-hub-master-plan_final.pdf).

guidelines for valuation models. This is an economical idea for standardizing the IP valuation model. This will reduce mistrust and will spread awareness in the market.<sup>57</sup>

Also it is needed that we have a comprehensive glossary of terminologies that defines all the commercial activities pertaining to IPR. This is because the term “assignment” is used to cover all types of transactions and does not distinguish between retention of title claim, providing license or different type of economic right. Assignment being an umbrella word includes all. Further, there is no term for intellectual property embodiments. All types of transactions of IPR if named systematically it will become easy for lenders to perform due diligence.<sup>58</sup>

Further, raising the quality of IP will help to curb uncertainty which directly attacks the IP market. For instance if the patent rights are granted for a product where technological boundaries are broad it may overlap with other patents, in such a case lenders will fear loaning, as in case of default they may not be able to recover the amount from the collateralized IP.<sup>59</sup> The USA is working on similar lines. The USPTO wants to adopt crowdsourcing of prior intellectual property, wherewith it will assemble up-to-date knowledge on any technical topic directly from the experts.<sup>60</sup>

While the countries are focusing on building efficient IP markets for their domestic use, Singapore is one step ahead and is aiming to make its market a global hub for IPs. Its global IP hub plan inter alia includes auction of IP assets. Such a set up inculcates confidence in lenders that IP can easily be liquidated in case of default.<sup>61</sup>

Government forms a chief constituent of the risk sharing instrument. Through its various schemes it can assure lenders to share the loss at pre decided percentage, and help lenders in paying loans. The UK's government EFG scheme is one such paradigm. Wherein the lender is provided government backed guarantee for 75% of borrowed amount, even so small businesses are required to pay 2% of the amount as premium. EFG comes into picture only when lenders

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<sup>57</sup>*Enquiries into Intellectual Property's Economic Impact*, OECD, 457, 470 (2015), <https://www.oecd.org/sti/ieconomy/Chapter9-KBC2-IP.pdf>.

<sup>58</sup>*Intellectual Property Rights-laws and Practices*, THE INSTITUTE OF COMPANIES SECRETARIES INDIA 1, 411 (2020), [https://www.icsi.edu/media/webmodules/FINAL\\_IPR&LP\\_BOOK\\_10022020.pdf](https://www.icsi.edu/media/webmodules/FINAL_IPR&LP_BOOK_10022020.pdf).

<sup>59</sup>Harhoff, Dietmar, *The role of patents and licenses in securing external finance for innovation*, 14 EIB Papers, 74, 81 (2009), <https://www.econstor.eu/bitstream/10419/44908/1/618784969.pdf>.

<sup>60</sup>*USPTO-led Executive Actions on High Tech Patent Issues*, USPTO (June, 2013), <https://www.uspto.gov/patents/initiatives/uspto-led-executive-actions-high-tech-patent-issues>.

<sup>61</sup>*Update to The Intellectual Property Hub Master Plan*, 1, 40 (2017), [https://www.ipos.gov.sg/docs/default-source/about-ipos-doc/full-report\\_update-to-ip-hub-master-plan\\_final.pdf](https://www.ipos.gov.sg/docs/default-source/about-ipos-doc/full-report_update-to-ip-hub-master-plan_final.pdf).

do not extend loans based on the IP or if they feel that there is no adequate security. Such schemes can conveniently be moulded and applied, since the scheme itself becomes a security that lenders feel safe. Although lenders will have to bear the loss of 25%, if SMEs are allowed to keep their IP as collateral and in the worst case scenario IP is not able to recover the amount the government will stand as a risk sharer. This will catalyse the process of collateralizing IP and extracting credit. Of Course this will put additional burden on the government but could be continued till the market adapts such a practice.<sup>62</sup>

The elementary form of aid by the government to this process will be allowing developmental banks to take IP as collateral. This is the widely accepted practice all over the world. Thais SME Bank, Brazilian bank that of China and Japan all developmental banks allowed IP based banking. Well the Brazilian banks practice IP audits before they lend to them.<sup>63</sup>

## SAFEGUARDING BANKERS INTERESTS

The dyed-in -the-wool tool for sharing the risk is insurance. So why not use it in this case as well? Insurance for IP is only given so as to mitigate the litigation cost in case of infringement, which is of no use to lenders.<sup>64</sup> So the idea of protecting lenders through insurance is to make such an arrangement which does not burden IP holders financially and at the same time secures the interest of lenders. Several companies have come up with different ideas to secure lenders through insurance.

Aon- an insurance company structured it by giving prevalent practice a little twist. Herein the role of an insurance company is to guarantee the lender to pay the pre-decided percent of debt in case of default, title of the IP will be passed to the insurer to recover the amount and if this fails the burden of loss will be on the insurer. Since the lender is insured from the risk, he will be liable to pay the premium.<sup>65</sup> Next in line is MCAM (Mitsubishi Chemical Advanced Materials), the process is similar as that of previous one, but MCAM also specializes in

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<sup>62</sup>Martin Brassell, Kelvin King, *The role of intellectual property and intangible assets in facilitating business finance*, INTELLECTUAL PROPERTY OFFICE, UK.1, 36 (2013), [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/312008/ipresearch-bankingip.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/312008/ipresearch-bankingip.pdf).

<sup>63</sup>ENQUIRIES INTO INTELLECTUAL PROPERTY'S ECONOMIC IMPACT, 457, 468 (2015), <https://www.oecd.org/sti/ieconomy/Chapter9-KBC2-IP.pdf>.

<sup>64</sup>Bethan Moorcraft, *Intellectual property insurance – an introductory guide*, INSURANCE BUSINESS ASIA (Sep. 10, 2019), <https://www.insurancebusinessmag.com/asia/guides/intellectual-property-insurance--an-introductory-guide-177405.aspx>.

<sup>65</sup>*How Aon is redefining the value of intellectual property*, INSIDER (Apr. 26, 2021, 8:53 PM), <https://www.businessinsider.com/sc/aon-is-redefining-the-value-of-intellectual-property-2021-4?IR=T>.

underwriting the value of IP and if it does not come out to be accurate the loss will be borne by itself. MCAM says that most of the companies that take advantage of their services are medium sized.<sup>66</sup> Another company known as BlueIron specializes in collateralizing patents, by securing itself through insurance.<sup>67</sup> Therefore this idea of risk sharing through insurance cover is a win-win situation for all the players in the game.

Due diligence by the lender can only protect the lender's interest. Not only is the owner of the IP but also the licensee entitled to keep IP as collateral. Due diligence of the lender includes ensuring that the borrower has the title and controls the collateral, determining the chain of title and all the conditions and terms of the license as it is often subjected to limitations. For instance, A is the owner of the movie and grants copyright to B with the proviso that he could only broadcast the movie in Indian Territory. If B seeks a loan against the movie and if he defaults, the lender will be able to use the collateral but subjected to the same obligations as B. Further, the lender must send notice to a third party informing them that the IP used by them is kept as collateral; only then will the lender priorities competing claimants as a secured creditor.<sup>68</sup>

Metis Partners performed (UK based commercial intellectual property consulting firm) IP due diligence on behalf of Clydesdale Bank Growth Finance (UK) as part of the fundraising process to ensure that DisplayLink's IP ( semiconductor and software technology company) portfolio firmly anchored the company's revenue streams. As a result, Clydesdale Bank believed that IP was a vital asset contributing to the business's economic value therefore accepted IP as a security for the loan extended to DisplayLink. This proves that an accurate due diligence can itself protect lenders to a larger extent.<sup>69</sup>

Negative pledge clauses are the most efficient way for lenders to prevent dispute in case of transfer of title after the default. It is a negative covenant, which automatically prevents the borrower from acting against the interest of lenders. Existence of a negative pledge clause will simply mean that the borrower is no longer entitled to gain more debt backed by already collateralized assets that could compromise its ability to repay existing loans. Secondly, it also

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<sup>66</sup> Martin, *supra*, 62, at.160.

<sup>67</sup> *Use Your Patents to Grow Your Company*, BLUEIRON (Dec. 15, 2012), <https://blueironip.com/loans-using-patents-as-collateral/>.

<sup>68</sup> *Security interests Draft legislative guide on secured transactions*, UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW 1, 3 (2007), <https://undocs.org/pdf?symbol=en/A/CN.9/631/Add.4>.

<sup>69</sup> Martin, *supra* note 62, at.136.



takes away the right of the borrower to dispose of the assets by any means without lender's consent.<sup>70</sup>

## RESPONSIBILITIES OF IP HOLDERS

When it comes to building trust, the burden is largely on IP holders, to convince them that their IP is capable of extracting the said amount in one go. Despite any safeguard to lenders, they won't lend unless they trust the quality of IP and its ability to bring back the amount lent. Hence it is important for the MSMEs to build up a narrative which clearly depicts the potential and risks associated with IP. This could be done by means of corporate financial reporting. The mechanism that generates a company's financial reports is known as corporate financial reporting. A corporate financial report not only displays a company's financial statements, but it also strives to emphasize important financial facts and demonstrate the implementation of financial policies.<sup>71</sup> Major worry in this situation is that IP is not included in the balance sheet of the company as an asset. This could be better understood if we compare it with the reporting of the acquired IP. Acquired IP is entered into the balance sheet in the form of transaction and is valued equal to its acquisition cost. Internally generated IP and cost of R & D is treated as immediate expense. Although it requires a lot of time, brainstorming and regular consumption of money, it is taken as one time cost which leads to the presentation of distorted information in the corporate financial report. The result is financial institutions perceive this as internally generated IP is not that worthy. Even if the IP holder sells, or licenses the IP it seems like profit is generated out of nowhere, as the balance sheet is not depicting credentials of IP and this also hinders the valuation process. The simple solution is to report IP as an asset with its features, and if possible the valuation in the corporate financial report which shall be comprehensible to the banks.<sup>72</sup>

Since the market is at nascent stage, in countries like India, governments can issue official guidelines on corporate financial reporting and can even coach the MSMEs on how to report their IP.

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<sup>70</sup>Marshall Hargrave, *Negative Pledge Clause*, INVESTOPEDIA (May 13, 2020), <https://www.investopedia.com/terms/n/negativepledgeclause.asp>.

<sup>71</sup>*Financial Reporting*, ACCOUNTING EDUCATION (Aug. 2011), <http://www.svtuition.org/2011/08/corporate-financial-reporting.html#comments>.

<sup>72</sup> *Supporting Investment in Knowledge Capital, Growth and Innovation*, OECDILIBRARY (Oct. 10, 2013), [https://www.oecd-ilibrary.org/industry-and-services/supporting-investment-in-knowledge-capital-growth-and-innovation\\_9789264193307-en](https://www.oecd-ilibrary.org/industry-and-services/supporting-investment-in-knowledge-capital-growth-and-innovation_9789264193307-en).

It has often been claimed that maintaining the quality of intellectual property requires maintaining its security. The safest way to keep an IP secure is to get insurance. Insuring IP will not only strengthen the IP of the company but also win the trust of lenders if the company is in need of funding.

In the Indian economy, the concepts of intellectual property and insurance are relatively new. The whole scope of the insurance idea is generally connected to legal fees and charges. Because of the lengthy registration procedure and the unpredictable nature of IP, the IP holder usually has little choice but to cover the expenses of legal actions.

Most common type of insurance for IP is patent insurance. Patent insurance often includes liability insurance for patent infringement, as well as the costs associated with it, and protects them from all variety of losses.

IP insurance may be divided into two categories:

1. Infringement defence - The most common form of IP insurance is infringement defense. It provides coverage for policyholders against infringement claims. It only covers the legal cost when the policyholder has been sued.
2. Abatement enforcement coverage — this coverage provides the financial resources for IP owners to enforce their IP rights and prosecute infringement claims. It not only covers the legal cost of the policyholder when sued but also when the policyholder wants to prosecute a claim against another party to enforce their IP rights.<sup>73</sup>

## CONCLUSION

When in need of money a farmer mortgages his land to raise funds so that he can cultivate crops in the next season, he does not sell off the land, as it is the only source of income. In the same manner MSMEs and start-ups have only few assets and mostly in the form of intellectual property when in need of money doing away with it is never an option. Hence the paper insists on creating an environment where IP backed loans are a hop, skip and a jump away. Surprisingly none of the ends are willing to enter into such a contract that is neither the

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<sup>73</sup>Bethan Moorcraft, *Intellectual property insurance – an introductory guide*, INSURANCE BUSINESS ASIA (Sep. 10, 2019), <https://www.insurancebusinessmag.com/asia/guides/intellectual-property-insurance--an-introductory-guide-177405.aspx>.

bankers nor the IP holder's reason being lack of effective communication and lack of government interventions and policies which create a lot of uncertainty in the market.

An IP-friendly environment is essential for any economy wishing to compete in the twenty-first century. The mature economies that priorities innovation in their economic policies has made visible steps to eliminate IP uncertainty and establish an IP commercial framework. Developing risk-proof model for collateralization of IP is like one time investment that will benefit economy for time immemorial. One should take lessons from IP friendly countries, frame a structure, implement policies, educate investors such as banks, MSMEs, IP holders on how the process of collateralizations of IP works and how it can benefit them, while keeping in mind that that the procedure is cost effective and user friendly.

After going through the research one could easily point out that although IP backed loans and other investments are hightailed but banks and investors exclusively dealing in IP are only ones interested in extending IP- Backed loans, consequently only corporate giants could afford their services. Hence it is high time for the countries such as India to make this service available for MSMEs and start-ups.

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