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LEGAL FRAMEWORK: CAPITALIZATION OF INTELLECTUAL PROPERTY IN INDIA

Intellectual Property ("**IP**") boosts the business by providing the exclusive right of monetisation of innovative and creative ideas. Every business entity classifies its assets as tangible assets (buildings, infrastructure etc.) which may be movable or immovable property or as intangible assets (IP and goodwill). Broadly, IP can be classified into patents (invented product/process), trademarks (brands, logos, words etc.), copyrights (literary/artistic/ dramatic works), industrial designs; geographical indications, trade secrets.

With the exponential growth in technology over the last 2 decades, businesses have seen an unparalleled growth in their intangible asset base as compared to tangible assets. One of the major reasons for this paradigm shift is the fact that tangible assets are depreciating assets that significantly lose their value over time as compared to intangible assets such as patent registrations, trademarks of a company, goodwill that are appreciating assets and continue to grow in value over time.

Prior to the evolution and growth of intangible assets, in a traditional financial market, loans or mortgages were usually provided only though the pledging of tangible assets of an entity. Today, we are however on the cusp of a major change in the way businesses procure funding using their IP assets as collateral. Banks are willing to explore to secure their credit facilities by creating enforceable security interest over an entities' IP assets. However, this practise is still evolving and is in its nascent stages in India with certain practical challenges which we have analysed in this article below.

Before, we explore the practical challenges faced by the banks or financial institutions, as a first step, we need to analyse whether creation of a security interest or collateral on IP is feasible under the applicable laws in India.

I. Is it feasible to create security interest or collateral on IP as an asset?

It is necessary for all entities to evaluate for themselves the feasibility of creating such a charge on their IP assets. One of the primary factors while creation of security interest or collateral on IP assets depends on the applicable law. It also depends on the banks and the type of IP assets being sought to be leveraged.

Here, we have analysed various applicable laws which encapsulate whether banks or financial institutions can create security interest or collateral on IP as an asset in the Indian context.

Applicable laws: In order to get a clearer understanding as to whether IP can be effectively used as a collateral, the IP acts such as Trademarks Act, 1999, Patent Act, 1970, Copyright Act, 1957, etc. (collectively referred to as "**IP Acts**") must be read in conjunction with the Companies Act, 2013, Banking Regulation Act, 1949, the Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002, Foreign Exchange Management Act, 1999, Reserve Bank of India, 1934 (collectively referred to as "**Commercial Acts**").

The relevant provisions of the Commercial Acts and IP Acts are provided below.

- **Commercial Acts**

    - **Companies Act, 2013**: Section 77 of the Companies Act 2013 *inter alia* provides that a company can create a charge on its property or assets or any of its undertakings situated in India or outside, whether the same are tangible or otherwise provided such charge is registered with the Registrar of Companies.

    - **Banking Regulation Act, 1949** ("**Banking Act**"): Section 6 of the Banking Act *inter alia* allows banks to do the business of borrowing, raising, taking up, lending or advancing of money either upon or without security as well as acquiring, holding and generally dealing with any property or any right, title or interest thereof, which may form the security or part thereof, for any loans or advances or which may be connected with any such security.

    - **The Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002** ("**SARFAESI Act**"): Section 2 (1) (zf) of the SARFAESI Act empowers a secured creditor to enforce any security interest created by the borrower in its favour, by way of a mortgage or an assignment. At this juncture, it is pertinent to point out that there are certain exemptions to the same under section 31 of the SARFAESI Act but IP assets do not find a mention as part of such exemptions.

    - **Foreign Exchange Management Act, 1999** ("**FEMA Act**"): While Section 2 (za) of FEMA Act which inter alia defines 'security', does not expressly include IP as a security, FEMA Act does not expressly disallow IP to be included within the purview of the definition of security. Transfer is defined under Section 2 (ze) of the FEMA Act to include sale, purchase, exchange, mortgage, pledge, gift, loan or any other form of transfer of right, title, possession or lien. Though transfer of security is allowed under FEMA Act, IP may or may not form part of the definition of security. Hence, creating security interest or collateral on the IP will depend on case to case basis as well as the authorized dealer bank.

    - **Reserve Bank of India, 1934** ("**RBI Act**"): Section 19 of the RBI Act lays down certain business which bank cannot transact. Though this list does not restrict granting loans and advance against IP specifically, it may act as an impediment for the banks to accepting IP as security or collateral.

- **IP Acts**

    - **Patents Act, 1970**: Section 68 read with section 69 of the Patent Act, 1970 allows creation of a security interest in a patent by the way of assignment or mortgage or license of a patent either wholly or in part. However, the creation of such a security interest on patent must be captured in writing and registered with the Controller General of Patents in a prescribed manner for it to be valid.

    - **Trade Mark Act, 1999**: While the Trade Mark Act, 1999 is silent on the creation of security interest over trademarks, it provides for assignment of a trademark either with or without goodwill. However, at this juncture it is pertinent to mention that while trademark(s) can form security or collateral for a loan, if it is not part of the collateral or security while procuring the loan it cannot be used by a defaulting borrower to repay the said loan. Thus, a trademark cannot be assigned to a bank by a borrower who has defaulted on the loan.[1]

- **Copyright Act, 1957** ("**Copyright Act**"): Since Copyright is a right that automatically vests in the creator irrespective of registration, it is not a preferred security or collateral. While the provisions of Section 18 and 19 of the Copyright Act allow for assignment of an underlying copyright in a work, the Copyright Act in itself is silent with regard to creation of mortgages or securities for loans. In day to day business banks may consider accepting registered copyright as collateral or security, however, unregistered copyrights, may not be considered as valuable collateral.

- **Designs Act, 2000**: Section 30(2) of the Designs Act, 2000, akin to the Patent Act, 1970 specifically allows the creation of a mortgage, license or security interest in a registered design by making an application to the Controller to register the title who shall issue cause notice of the interest in the prescribed manner in the register of designs for creating such interest.

Thus, a brief analysis of the IP Acts prima facie shows that while some acts specifically mention that charges or liens that can be placed on the IP assets, a majority of them are silent on it. The banks and/or other financial institutions face various practical obstacles and may abstain in accepting IP assets as collateral or security.

II. Challenges faced for creation of security interest or mortgage or collateral on IP assets:

Some of the major challenges in IP financing include valuation, banking regulations, legal enforceability and liquidity which have been briefly explained as below:

- **Due Diligence and Valuation of IP:** Before banks and/or financial institutions accept IP as collateral, a due diligence is usually undertaken by them which is often a time-consuming and cost intensive process. A thorough due diligence helps them to ascertain the actual value of the IP sought to be pledged or mortgaged with them as well as the shortcomings of the IP assets. Lenders may need specialized expertise to understand the specific industry, technology, or creative field related to the IP assets. One of the biggest hurdles faced by the banks for giving loans against IP assets is its valuation. Determining the true value of IP can be challenging, and different appraisers might arrive at different values. There are no guidelines which have been formulated for IP valuation that are uniformly followed by all the lending institutions. Ascertaining the value of an IP assets is an uncertain and complex process that often involves a combination of quantitative analysis, market research, and qualitative assessments such as legal protection, the company's ability to enforce its rights, the level of brand recognition and reputation in the market, market positioning, customer loyalty and relationships, financial performance, geographic reach, industry trends, etc. as well as unique characteristics of the business and its industry. The market's perception of the value of IP assets might not align with the lender's assessment and the value may not translate directly to financial value in the eyes of potential buyers or investors.

- **Continuing validity:** The value of IP assets is primarily derived from its registrations. Additionally, registration of IP is prima facie proof of exclusive ownership of the said IP. However, since most IP registrations are time bound, it is imperative that banks and/or financial institutions include within the borrower documentation nomenclature to ensure

[1] Canara Bank v. N.G. Subbaraya Setty & Anr ((2018) 16 SCC 228)

that the borrower takes all the necessary precautions to ensure that the ownership of the said IP assets remain valid, unencumbered and exclusively in favour of the borrower. Failure to do so will result in the borrower having a faulty title and result in loss of value of the IP asset. Lapse in registration of pledged IP assets may make the enforcement of security against the said IP assets more difficult, expensive and time consuming.

- **Fluctuating market value and lack of tangibility:** The value of IP assets can fluctuate over time and can make it hard for both the borrower and the lender to predict the long-term value of the collateral. IP assets may not have the ability to realise its resale value as compared to tangible assets. IP assets lack physical presence, which can make them more difficult to seize and liquidate in case of default and cannot be easily sold off to recover the loan amount. A specific mechanism is required to be included in the written security documents to secure the interests of lenders, as often it becomes difficult to assess the resale value of IP.

- **Enforcement and monitoring:** Monitoring and enforcing the value of IP assets can be more difficult compared to tangible assets. Protecting against infringement, maintaining the quality of the IP assets, and ensuring its ongoing relevance can be challenging. Lenders may need to invest in ongoing monitoring to protect their interests.

- **Legal complexity:** IP law can be intricate and varies from jurisdiction to jurisdiction. Lenders need to be aware of potential legal issues surrounding the IP assets, including the possibility of third-party claims, challenges to ownership, and potential disputes that could impact the value of the collateral.

- **Liquidity concerns:** It can be challenging to find buyers for IP assets, especially if they are highly specialized or require a specific market to generate revenues. This lack of liquidity can impact the lender's ability to recover their investment quickly.

- **Dependence on IP:** If a company's main value lies in its IP assets, using them as collateral can introduce risks. The intrinsic value of the IP may be contingent on the presence of the other assets which are embedded in the business as a whole. In the event of default, the company might lose access to its core assets, which could have broader negative implications for its operations. It is therefore imperative for entities to create strong and separate IP portfolios to explore this option of financing.

- **Market changes and technological obsolescence:** IP is prone to technological obsolescence due to rapid development in technology, consumer preferences, or industry trends plus less valuable. Hence, calculating the return on investment for any technology-related IP is difficult and uncertain for the banks and other financial institutions.

- **Enforceability in law**: Enforceability in law will also bring lot of challenges in the times to come. Various laws have to be revisited and amended to accommodate the IP financing in India to create uniformity amongst the lenders.

III. Benefits of creation of security interest or mortgage or collateral on IP assets:

IP assets as collateral is an untapped source of financing. There are certain benefits for the business to create security interest or mortgage on IP assets such as:

- Using IP assets as collateral can provide additional security for loans, allowing businesses to access financing they might not otherwise qualify for. This in turn helps the companies to widen their scope of financing and explore new options available for their business.

- It can be an alternative to providing traditional assets, like real estate or equipment, as collateral.

- For businesses with valuable IP portfolios, this approach can be a way to leverage their intangible assets for funding. Building a strong IP portfolio will allow the company to explore this option.

CONCLUSION

Although there is no express restriction under the law to create mortgage, lien, encumbrance, security interest or collateral on IP assets, in the absence of a regulatory framework it is completely at the discretion of the banks and/or financial institutions to accept IP assets as a security for financing.

IP backed financing exists as a tool to ease access to credit. One of the most common ways of securing the lenders legal claim over the IP assets, is to provide public notice that the IP assets are being used as collateral for a loan.

Another way forward to facilitate the use of IP assets as collateral or security will be to create transparency in the market place so that strong relationships between entities with well-built IP portfolios and financing entities for IP backed financing are utilised to its full possible extent.

Given the challenges, lenders and borrowers considering using IP assets as security for a loan should carefully assess the risks and benefits, conduct thorough due diligence, and consider consulting with legal and financial experts who specialize in intellectual property. This will enable to safeguard interest of the lender as well as the borrower.

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