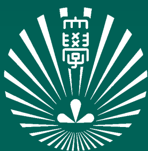
Perspectives in Law, Business and Innovation

Toshiyuki Kono *Editor*

Security Interests in Intellectual Property



Perspectives in Law, Business and Innovation

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Over the last three decades, interconnected processes of globalization and rapid technological change—particularly, the emergence of networked technologies—have profoundly disrupted traditional models of business organization. This economic transformation has created multiple new opportunities for the emergence of alternate business forms, and disruptive innovation has become one of the major driving forces in the contemporary economy. Moreover, in the context of globalization, the innovation space increasingly takes on a global character. The main stakeholders—innovators, entrepreneurs and investors—now have an unprecedented degree of mobility in pursuing economic opportunities wherever they arise. As such, frictionless movement of goods, workers, services, and capital is becoming the "new normal".

This new economic and social reality has created multiple regulatory challenges for policymakers as they struggle to come to terms with the rapid pace of these social and economic changes. Moreover, these challenges impact across multiple fields of both public and private law. Nevertheless, existing approaches within legal science often struggle to deal with innovation and its effects.

Paralleling this shift in the economy, we can, therefore, see a similar process of disruption occurring within contemporary academia, as traditional approaches and disciplinary boundaries—both within and between disciplines—are being re-configured. Conventional notions of legal science are becoming increasingly obsolete or, at least, there is a need to develop alternative perspectives on the various regulatory challenges that are currently being created by the new innovation-driven global economy.

The aim of this series is to provide a forum for the publication of cutting-edge research in the fields of innovation and the law from a Japanese and Asian perspective. The series will cut across the traditional sub-disciplines of legal studies but will be tied together by a focus on contemporary developments in an innovation-driven economy and will deepen our understanding of the various regulatory responses to these economic and social changes.

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Security Interests in Intellectual Property

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ISSN 2520-1875 ISSN 2520-1883 (electronic)
Perspectives in Law, Business and Innovation
ISBN 978-981-10-5414-3 ISBN 978-981-10-5415-0 (eBook)
DOI 10.1007/978-981-10-5415-0

Library of Congress Control Number: 2017947467

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Printed on acid-free paper

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The registered company is Springer Nature Singapore Pte Ltd.
The registered company address is: 152 Beach Road, #21-01/04 Gateway East, Singapore 189721, Singapore

Preface

The importance of intellectual property in business management has been widely recognized. It applies not only to big corporations, but also to small- and medium-sized enterprises. It seems, however, that there is much less discussion on the issue of intellectual property and finance. This book is edited with the aim to contribute to the development of debates on how intellectual property could contribute to the finance of its holder. For this purpose, it is crucial to integrate interdisciplinary perspectives. Scholars in the fields of law, economics, business administration, as well as an expert in international organizations, are invited to participate in this project. This is an outcome of a research project funded with JSPS Kakenhi Grant (Type S).

Fukuoka City, Japan Toshiyuki Kono

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IP Debt Finance and SMEs: Revealing the Evolving Conceptual Framework Drawing on Initiatives from Around the World

Janice Denoncourt

> *Just as physical assets were used to finance the creation of more physical assets during the industrial age, intangible assets should be used to finance the creation of more intangible assets in the information age.*
>
> —Intangible Asset Monetization, Athena Alliance, 2008

Abstract This chapter surveys and analyses how the increased integration of the intellectual property (IP) rights system within the globalized economy could accelerate business outcomes for young IP-rich small and medium size enterprises (SMEs) if lenders adopt a new mind-set to IP-backed debt finance. The phenomenon of globalization, namely, the increased interconnectedness of the world's countries, has a profound influence on the business, legal and finance framework. In this post-financial crisis environment, the banking and finance sector has largely retreated from traditional lending practice. Although access to finance is a universal issue, how can IP-backed debt finance grow in a globalized world? What IP finance trends and initiatives are currently afoot to support national competitive advantage and economic growth? The range of international initiatives to enhance IP-backed debt finance has never been fully explored in any of the innovation or IP finance literature. This chapter reviews a variety of international initiatives being undertaken to facilitate the expansion of IP-backed debt finance to improve liquidity and to support young IP-rich SMEs in the UK, the E.U., the US and Asia. It attempts to set a high level agenda for informing IP debt financing for SMEs policy. It also analyses the contributions of certain regional Intellectual Property offices, international inter-governmental organizations, the World Intellectual Property Office (WIPO), the United Nations Commission on International Trade Law (UNCITRAL) and leading commercial banks in this regard. By combining the body of knowledge emanating from over two decades of developments from a global perspective, this chapter

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T. Kono (ed.), *Security Interests in Intellectual Property*, Perspectives in Law, Business and Innovation, DOI 10.1007/978-981-10-5415-0_1

provides a synthesized understanding to inform future IP finance policy directions. It introduces the systemic changes needed to support the agile development of globally enhanced SME access to IP finance in the post-recession economy.

1 Introduction

Governments in a number of countries are evaluating their intellectual property (IP) frameworks to further their understanding of how IP can help shape sustainable economic growth, whether they are mature economies who wish to maintain their competitive edge in the global market, or emerging economies seeking to build up their economic base. This chapter focuses on intellectual property (IP) assets within the context of the wider term 'intangible assets'[1] which includes such things as goodwill or intellectual capital. The internationalization of the debate over the viability of IP-backed debt finance is due in part to the increasing economic importance of IP. IP is a bundle of legally created rights that arise through law.[2] The term IP itself refers to: creations of the mind, such as scientific inventions; literary and artistic works; designs; and commercially employed symbols, names and images. In the IP law framework, they entail complex intangible legally recognized exclusive rights.[3] In order to come into existence, some IP rights must be registered with the relevant national statutory registry (e.g., patent, trademark and design registries) though certain IP rights subsist even as unregistered rights (e.g., copyright and confidential information). IP rights are personal property rights protected in law, which enable people to earn recognition or financial benefit from what they invent or create. IP is like any other property, allowing the creators, inventors or owners of IP rights to benefit from their own work or investment in a creation by licensing or selling their IP rights.[4] As such, in commercial terms they are assets which can be used to generate additional value or provide liquidity and in accounting terms, assets are credits to the balance sheet.

[1]In accounting, banking and finance and company law terms, intangible assets are those whose value equals the aggregate market share value less the portion that can be explained by tangible assets.

[2]IP rights are intangible assets are assets that do not have a physical or financial embodiment. They have also been referred to as knowledge assets or intellectual capital in other non-legal disciplines.

[3]See WIPO (2011), http://www.wipo.int/publications/en/details.jsp?id=99&plang=EN. Accessed 13 May 2017.

[4]See WIPO (2011), http://www.wipo.int/publications/en/details.jsp?id=99&plang=EN. Accessed 13 May 2017. IP rights are confirmed in Article 27 of the Universal Declaration of Human Rights and their importance was first recognized in the Paris Convention for the Protection of Industrial Property (1883) and the Berne Convention for the Protection of Literary and Artistic Works (1886). Both treaties are administered by WIPO.

From a legal perspective however, most jurisdictions do not offer adequate legal means for IP financing, a concept which refers using IP rights to obtain or secure finance. We should first specify what is meant by 'security'. The basic questions of the theoretical literature concern why debtors grant security for their loans and how security is used by debtors to mitigate market imperfections and whether this is socially beneficial.[5] In Anglo-American law secured finance provides asset-based priority credit. A secured debt has full priority over any unsecured claim on insolvency. Certain academic fields such as law, economics, accounting and finance are increasingly aware of these deficiencies, and the issue of IP financing is the subject of policy development at the international level. Although IP policy is now firmly established in the political arena, there is still a need to help governments understand the different components needed to create a platform to encourage IP financing of transactions and to stimulate the growth of innovative and creative industries.

Further, across the world the mainstream financial press is now more aware of the value of IP assets as a core component of business strategy. High profile IP corporate finance stories with global impact have been widely reported in recent years. These involve multi-national companies operating in a variety of industrial sectors, including Apple, Disney, Facebook, GSK, Lucasfilm, IBM, Microsoft, Samsung, Sony, Toshiba, Panasonic and Pfizer, to name a few. Although the increased awareness of the value of IP assets has mainly focused on high profile global corporations, in most OECD[6] countries it is small-to-medium sized enterprises (SMEs) that generate between 60 and 70% of employment and make the most significant contribution to economic growth in the globalized world. Many of these SMEs are constrained in their access to traditional banking or debt financing due to a lack of traditional security. The IP system is a precondition for the markets for technologies, innovations and creative activities that are often developed by SMEs. Young SMEs are also often linked to universities and research institutions, which are themselves also using IP assets to leverage their research and work with commercial partners.[7]

Why are IP rights valuable as commercial assets? The fundamental value of IP arises from its exclusivity. The law confers the right or ability of the IP owner to exclude others, assuring its uniqueness. This enables the owner the time to monetize

[5] Siebrasse (1997), https://www.researchgate.net/publication/237830835_A_Review_of_Secured_Lending_Theory, pp. 2–3.

[6] The Organization for Economic Cooperation and Development.

[7] An overview of business and government action is published by the International Chamber of Commerce (ICC) in its biennial publication. See https://iccwbo.org/media-wall/news-speeches/icc-releases-2014-intellectual-property-roadmap. Accessed 17 May 2017. This link provided contains the 2014 press release and has now been updated with the full text of the ICC IP Roadmap 2017. See ICC (2017), https://cdn.iccwbo.org/content/uploads/sites/3/2014/11/icc-IProadmap-intellectual-property-roadmap-current-emerging-issues-business-policymakers.pdf. Accessed 18 May 2017.

personal innovations and creations by the route that creates greatest corporate value without undue concern that third parties will copy them. IP rights also confer pricing power. The value of an IP right (or portfolio of IP rights) is basically the value of supra-normal profits earned from exploiting the innovation or creation, compared with what might be earned without the IP right. The commercialization of innovations and creations and the IP rights that protect them are therefore two different issues. For example, if a patent is declared invalid, the IP owner may still beat other competitors to market and thus earn revenue from the invention. Conversely, if that owner fails to develop the invention, a revenue stream can still be earned from the patent by licensing out to others the right of its use.[8] In theory, young IP-rich SMEs are less likely to suffer margin erosion, and this should be central to a lender's valuation as a form of security.

For our purposes, the company law term SME refers to young enterprises involved in IP creation, whether with respect to innovation or the creative sector. We assume here that the young SME with IP assets adopts a private limited company legal structure in the relevant international jurisdiction. SMEs do not issue publicly tradable securities, making such enterprises reliant on credit from banks to grow their businesses. With quoted share offerings listed on a stock exchange and available to the public as well as to large private companies the value of intangible IP assets is recognized in their market value. However, for unquoted SMEs there is no comparable mechanism to measure and demonstrate how IP assets will create value for their business for use as security for bank loans.[9]

There are four reasons for the interest in enhancing young SME access to IP-backed debt finance.

First, there is the scale of commercial value dependency on intangibles and IP assets, which has often been recognized.[10] A growing body of research shows rapid expansion of investment in intangible assets by companies in the United States (US), Japan and Europe, with significant impact on productivity. Data shows investment in IP assets is growing and continues to outstrip investment in tangible assets. In many countries, the proportion of 'off balance-sheet' assets to 'on-balance-sheet' assets (the price-to-book ratios of companies) has risen for decades. These figures signal the growing value business attaches to knowledge, innovation and creativity. Young SMEs in the technology and creative industry sectors are likely to be IP-rich. In terms of fundamental policy relating to secured debt finance, high-growth, young IP-rich companies typically do not possess suitable security on their corporate balance sheets for financing from a capital

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[8]See Walmsley (2001).

[9]See Garrett (1995), p. 99.

[10]New figures published today (21 March 2014) show that UK business is building success through knowledge and creative assets. See UK Department for Business, Innovation and Skills and Viscount Younger of Leckie (2014), https://www.gov.uk/government/news/uk-knowledge-investment-continues-to-grow. Accessed 13 May 2017.

adequacy perspective (IP is a 100% risk-weighted asset).[11] Thus the corporate finance options for young IP-rich SMEs are limited and they remain largely dependent on bank lending to raise capital due to limited means of self-finance (e.g., savings, government grants etc.) and the high cost of equity finance. Debt finance is advantageous for SMEs as it is typically less expensive than other funding methods and does not involve diluting equity in the business. Operationally, it is relatively easy to implement. Yet, most lenders only rarely identify and consider IP assets in SME credit appraisal decisions, instead focusing their attention on the familiar: traditional tangible assets such as land and equipment.

Second, as early as 1979 it has been known that the smaller the borrower, the more likely security will be required. In other words, smaller risker borrowers are more often required to provide security.[12] This is because security is traditionally regarded by lenders as a signaling device to indicate poor quality borrowers rather than good quality borrowers who are able to rely on their cash flow and income streams to repay loans. In terms of secured lending theory, this directly affects IP-rich SMEs in the innovation and creative sectors.

Third, following the global financial crisis which began in 2007,[13] SME access to finance was formally recognized as an issue of pressing importance at the G20 summit held in 2009.[14] Since that period, the ability and willingness of commercial banks to fund SMEs globally has generally declined despite government initiatives to increase lending. At the same time, a bank loan or commercial mortgage is the preferred method of finance.[15]

Fourth, young IP-rich SMEs are largely dependent on bank lending to raise capital as it does not involve diluting equity and control of decision-making within the business is retained by the directors.

[11]Capital regulation requires that a sufficient fraction of a bank's investments or assets be funded with un-borrowed money. Because un-borrowed funds are obtained without any promise to make specific payments at particular times, having more equity enhances the bank's ability to absorb losses on its assets.

[12]Hester (1979), pp. 349–57. The pilot survey gathered information on 1072 business loans of $10,000 or more made by sixty-two banks in 1972.

[13]See The run on the Rock Fifth Report of Session 2007–2008 House of Commons Treasury Committee (2008) Vol. 1, House of Commons London: The Stationer Office Ltd p. 4–20. Also known as a credit crunch, it is a decline in the general availability of loans (or credit) coupled with a tightening of the conditions required to obtain bank loans. A credit crunch is accompanied by a "flight to quality" by lenders, as they search for less risky investments, often at the expense of SMEs.

[14]See G20 (2009), https://www.oecd.org/g20/summits/pittsburgh/publicationsdocuments/. Accessed 13 May 2017.

[15]See Lomax and Davies (2013), http://www.bmgresearch.co.uk/sme-journey-towards-accessing-external-finance/. Accessed 13 May 2017. A Report by BMG Research commissioned by UK Department of Business and Innovation in p. 68 which found that for banks loans were preferred by 36% of SMEs, followed by a bank overdraft (23%) and loans/equity from friends and family (10%).

Against the dramatic rise of IP value as a percentage of corporate value is the setback from the contraction of the banking sector and the availability of financing for growth across the globe generally. Therefore, even though IP rights are corporate assets that drive technological 21st century innovation and the creative industry, IP-backed debt finance is underdeveloped in virtually every country in the world due to the understandable risk-aversion of many banks in dealing with intangible IP assets which they find difficult to identify, value and register their security interest. Secured creditors enjoy a priority status in insolvency (bankruptcy) situations and are repaid ahead of unsecured creditors and company shareholders. Nevertheless, the use of intangible IP assets as security for loans has existed for over a century and needs to grow and eventually become commonplace if young SMEs are to thrive in the post-recession economy.

The advantage of IP rights as corporate assets is that in addition to creating a new asset which can be used as a source of security for loans, IP assets have the potential to create a royalty revenue stream, to bolster financial statements and to provide a shield against aggressive competitors. However, this requires a largely upfront financial investment by the owner. IP-savvy young SMEs accumulate as many IP rights as possible with a view to maintaining their discretion in choosing the most suitable commercialization strategy. When funding is limited, young SMEs focus on acquiring those IP rights that are most likely to generate a financial return. Imperfect access to debt finance funding has a comparatively greater negative impact on young SMEs at the beginning of the business life cycle. This is because entrepreneurs and young SMEs frequently lack the internal financial resources to engage in the IP rights registration process that supports commercialization, compared with larger firms who have more finance and security options.[16] Lenders prefer to deal with registered granted IP rights because they are legally enforceable against infringers, more liquid and therefore seen as more valuable. There are also gaps in the level of finance and IP law knowledge among many young SMEs and lenders.[17] There is a pressing need to facilitate the use of IP as the underlying asset in a loan transaction to support young SMEs worldwide. Poor—or non-existent—access to financing is the main barrier to achieving growth aspiration plans that underpin nation states' economic goals.[18] This chapter proceeds as follows: the debt versus equity debate is examined in Sect. 1 and provides a theoretical framework for the discussion of the international initiatives to facilitate IP-backed debt finance in Sects. 2, 4 and 5. Following the critical analysis of the global initiatives, Sect. 6 introduces the concept of 'systemic change' and a new conceptual framework for IP finance, with a view to informing policy to support the agile development of globally enhanced SME access to IP finance.

[16]See European Commission (2012), p. 18, https://www.iprhelpdesk.eu/node/867. Accessed 13 May 2017.

[17]See Gower (2006), p. 3, https://www.gov.uk/government/publications/gowers-review-of-intellectual-property. Accessed 13 May 2017.

[18]Federation of Small Business (2012), http://www.fsb.org.uk/docs/default-source/Publications/reports/fsb_2012_access_to_finance.pdf?sfvrsn=1. Accessed 17 May 2017.

1.1 IP Finance and SMEs: Debt Versus Equity

IP-backed debt finance simply involves using a portfolio of IP rights as security (collateral)[19] for a loan.[20] However, most lenders rarely consider IP assets in SME credit appraisal decisions, instead focusing their attention on the familiar: namely, traditional tangible assets. However, the duration of the IP rights, some of which have the potential to exist indefinitely (registered trademarks and confidential information) allowing lenders to forecast revenue and possibly enabling the young SME to generate high-value income through licensing, thus reducing cost/income ratios. Debt finance needs to become a viable alternative to venture capital (VC) and private equity finance, the availability of which has also decreased over the past decade.

1.2 Equity Finance

In terms of access to finance, economies with robust IP regimes are more likely to attract venture capital and private equity funding.[21] IP assets are a resource with great appeal for venture capitalists; however, a variety of finance options is needed by young IP-rich SMEs, given the decline in VC investment since the onset of the global financial crisis in 2008. Presently there are fewer markets for initial public offerings (IPOs) as companies stay private for longer periods of time. Further, in many jurisdictions, especially in Asia, South America, Africa and the Middle East, the IPO market is small and/or immature. For example, even in a highly developed nation such as Japan, the amount of investment by Japanese VC is very small compared with that of North America and Europe.

Unsurprisingly, companies increasingly seek financing from outside the VC arena. VC finance is limited by the fact that it primarily serves the capitalist interests of VCs over the public's interest in supporting innovation and creative activity. In other words, what VCs choose to invest in may not take into account the public interest and ultimately may limit choice in the innovation ecosystem. It is suggested that if governments would take a more active role in shaping the activities of lenders to enhance SME access to IP-backed debt finance, this would reduce the need for VC finance and increase the likelihood of young SME business activities

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[19]Collateral is the American term for "security".

[20]In many OECD countries, investment in intangible assets is growing rapidly. In some cases, this investment matches or exceeds investment in traditional capital. Intensified global competition, ICTs, new business models, and the growing importance of the services sector have all amplified the importance of intangible assets to firms, industries and national economies.

[21]Global Intellectual Property Center of US Chamber of Commerce (2016), http://www.theglobalipcenter.com/wp-content/themes/gipc/map-index/assets/pdf/2016/GIPC_Index_2016_Final.pdf. Accessed 13 May 2017.