

SECURING A LOAN USING INTELLECTUAL PROPERTY:

A PRACTICAL FINANCING APPROACH
FOR STARTUPS IN NIGERIA

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INTRODUCTION

The concept of Intellectual Property (IP) is predicated on the notion that certain products of human intellect should be afforded the same protective rights that apply to tangible assets and is therefore, intangible property emanating from creativity and innovation, which can be owned like physical property. It applies to creative ideas, such as inventions; literary and artistic works; designs; symbols, names, and images used in commerce. Furthermore, The World Intellectual Property Organization (WIPO) classifies Intellectual Property Rights (IPR) to include:

'... literary, artistic, and scientific works; performances of performing artists, phonograms, and broadcasts; inventions in all fields of human endeavour; scientific discoveries; industrial designs; trademarks, service marks, and commercial names and designations; protection against unfair competition; and all other rights resulting from intellectual activity in the industrial, scientific, literary, or artistic fields.'

Globally, IP has grown into one of the fastest-growing fields of law. In Nigeria, IP is still evolving and can be categorised broadly into four areas namely - copyright, trademarks, patents and designs.

In a general sense, most businesses own potentially valuable but unutilised IP Rights. The ability to raise capital is a major catalyst for economic growth and development and a company's ability to raise capital can either actualize or undermine its goals. The essential nature of funding in business actualisation requires companies to seek funding that requires collateral. With IP's rising importance and value, companies are now exploring how to utilize their IP for revenue generation and how to leverage their IP as collateral to secure funding to support business growth. This article aims to consider IP as security for financing startups in Nigeria.

IP AS A FORM OF SECURITY UNDER THE STARTUP ACT

A Startup broadly defined is a company in its early stages of operations. The Nigerian Startup Act (the "Act") defines it as "a company in existence for not more than 10 years, with its objectives being the creation, innovation, production, development or adoption of a unique digital technology innovative product, service, or process".

The growth of every business organisation, more so, a Startup is usually capital intensive, requiring the founders/promoters to source funds to become/remain operational. However, the lenders granting these facilities often require security over real property or tangible assets as the most common form of collateral. Given these preferences by lenders, for many IP-rich but cash-restrained small businesses and Startups, the traditional financing options like real property or tangible assets may be unavailable or too expensive.

Section 28 of the Startup Act makes provisions for Startup Investment Fund and specifically, the Credit Guarantee Scheme allows credit to be extended to Startups in the country, secured by the IP materials of these Startups¹. This facility is provided only for the development and growth of a statutorily labelled Startup.

¹ <https://www.wipo.int/about-ip/en/> (Accessed May 2, 2023)

² The Convention Establishing the World Intellectual Property Organization, Article 2 (viii).

³ Section 47 of the startup Act, 2022.

VIABILITY OF IP AS A COLLATERAL FOR FUNDING

IP assets are becoming increasingly popular in developed jurisdictions, and as a result companies and asset-based lenders have turned to IP portfolios as a form of collateral to secure their loans.

Section 222 of the Companies and Allied Matter Act (2020) (CAMA), allows companies to create security interests in their IP assets. Such interests, when created, must be registered with the Corporate Affairs Commission (CAC) as a charge on the company's assets within ninety (90) days after the date of its creation. It follows that IP as security is recognized by our laws.

Security over IP can take the form of securitisation, a legal mortgage, a fixed charge, or a floating charge. The decision as to which security option is to be exercised over the borrower's portfolio will be largely determined by whether the security is being granted over registered or unregistered IP materials

Securitisation

Asset securitization is the practice that allows a company, called the originator, to pool assets with a predictable stream of income, and repackage or convert them into interest-bearing and marketable security to raise financing for its business. The pooled assets will be sold to an issuer, which is usually a special purpose vehicle (spv) that will then issue them as security to investors. Therefore, IP securitisation is the practice of pooling IPRs and assigning the royalties due on the IPRs to an

spv in exchange for capital.

To protect the interest of the lender or creditor in the securitisation of IP rights, the lender must conduct proper due diligence to ascertain the quality of the IPRs assigned, since the lender may not have recourse to other assets of the borrower. Thus, the quality of IPRs, whether they are performing, or non-performing would assist the lender in making its final decision.

Mortgage

A legal mortgage is generally the preferred choice, where the IP right is registered. This is done by way of an assignment which should include warranties that the borrower owns the IP; that there are no claims for infringement against the borrower or prior security interests; and that the legal title to the IP will also be transferred to the lender, while simultaneously the borrower will retain a beneficial equitable interest in the mortgaged IP with the equity of redemption.

Moreso, the borrower will be entitled to the re-conveyance of the legal title upon fully discharging its debt. At the same time, a license will be granted back to the borrower to allow use of its IP. The License-back must contain an obligation on the borrower not to do anything that may damage or reduce the value of the goodwill in the IP. The lender should also be permitted to terminate the licence if the borrower defaults on the loan. The intention here is not to transfer the debtor's IP to the lender but rather to use the IP only as security for repayment of the debt.





Fixed and Floating charge

A fixed charge is created over ascertained and definite property of a debtor and attaches to the property from the time of its creation. The charge restricts the rights of the debtor to deal with the charged property, without the consent of the party in whose favour the charge is created. A floating charge is a security over the assets of the company for the time being, i.e., over all or some parts of its present and future property as a going concern. The difference between fixed and floating charges relates to the debtor's ability to dispose of its assets. With a fixed charge, it has a very limited ability to do so but with a floating charge, it is free to dispose of its assets in the ordinary course of business.

Ideally the charge should also be granted by the borrower with full title guarantee; the implication is that the borrower guarantees that it has the right to grant a charge over the IP in favour of the lender and that the IP is free from other charges, encumbrances, and other rights exercisable by third parties other than charges, encumbrances, or rights that the lender could reasonably be expected to know about (such as interests registered against the IP at the Patent Office).

In the event of the borrower's default, the lender could sell the secured IP to pay off any existing loan obligations of the borrower. Ideally, the underlying security agreement should give the lender the power of sale and a power of attorney to deal with the IP. Without an express power of sale, the lender will have to apply to Court for an order of sale or the appointment of a receiver. If, however, security has been granted by way of a deed, the lender will have a statutory power of sale and right to appoint a receiver, exercisable without the need to apply to Court. While the IP remains subject to a fixed charge, the lender should restrict the borrower's ability to deal with the asset.

As title to the IP secured by the fixed charge remains vested in the borrower so also does the maintenance of the IP. It is therefore important that the security agreement obliges the borrower not to jeopardise either the enforceability or validity of the IP (including failure to pay renewal fees or act against infringers)

In transactions where the unregistered IP of the borrower is of little commercial value, security will usually be taken by including these rights under the general list of assets of the borrower secured by a

floating charge. Fixed charges on the other hand grant the lender an interest in specific assets of the borrower, and as such, the borrower is prevented from dealing with the charged asset without the consent of the lender.

DUE DILIGENCE:

Some important issues that the Due Diligence should cover include: Are the IP rights legally owned by the debtor (as opposed to being used under a license from the owner)? What is the state of compliance, and have all costs related to the registered IPs been paid to protect their registration status? Are there any pending liens, foreclosures, or other types of claims against the IP rights? Is the remaining term (with renewals if applicable), subject to expiration (like patents and trademarks), adequate for the security transaction? While certain IP rights are renewable, IP rights in and of themselves are never indefinite.

Section 23 of the Trademarks Act provides that the registration of a trademark shall be for a period of seven years but may be renewed from time to time. Patents, on the other hand, have a limited term. Section 7 Patents and Design Act, 2004 provides that the term of a patent shall be twenty years from the filing date. Schedule 1, Copyright Act, 2004 provides that for literary, musical, or artistic works other than photographs, the copyright subsists from the date of creation and expires seventy years after the end of the year in which the author dies.

The value of the IP, which is possibly the most significant aspect of employing IP as security, would also need to follow a set protocol. A poor value (overvaluation or undervaluation) of an IP might have detrimental effects on the entire

arrangement. The extent to which an IP is registered and in which countries, the level of competition (alternatives), the amount of revenue an IP has produced recently, the size and projected growth of the markets for the innovations, etc. are some of the important factors to be considered when pricing an IP.

Following due diligence, the value of the IP must be ascertained to determine whether it will be a good basis for providing security. Factors relevant to the value of any IP right will include the type of right, its strength, the number, and value of similar products on the market, the cost of maintaining and policing the right, and the potential to license or sell the right to others in the market. It is worth noting that a considerable gap often exists between the value of IP assets examined for collateralization and the value of IP assets following a default.

Another issue is obsolescence, which occurs when the present owner of the IP does not fully use the potential of the IP through upgrades. The value of IP connected to older products decreases as new items enter the market. Smartphones are a prime example, where the industry leaders like Apple, Samsung, etc. continue to release new devices. Eastman Kodak paid a high price for neglecting the advantages of digital photography, which it pioneered, handing late entrants a sizable market share and leadership. This long-term pattern explains why a patent for certain technology may lose a lot of value after a few years.



BENEFITS OF INTELLECTUAL PROPERTY AS A SECURITY

Using IP as collateral for funding can offer several benefits to both borrowers and lenders:

- I. **Access to Financing:** provides businesses with an additional source of security to secure funding, which is particularly valuable for startups and innovative companies with limited physical assets but valuable IP assets.
- ii. **Diversification of Collateral:** For borrowers, using IP as collateral allows for diversification of collateral pool beyond traditional physical assets.
- iii. **Unlocking Value:** IP assets often have untapped value that can be leveraged for funding. Borrowers can use their IP rights to access capital without selling the underlying assets, enabling them to retain ownership and potential future revenue streams.
- iv. **Maintaining Control:** When IP is used as collateral, the borrower retains operational control over the IP assets. This is different from selling the IP outright, and a loss of control over its use and potential revenue.
- v. **Flexible Repayment:** Depending on the terms of the loan agreement, borrowers might have more flexibility in repaying the loan which can be structured to align with the cash flows generated by the IP assets.
- vi. **Interest Rates:** Depending on the perceived value and strength of the IP, borrowers might be able to negotiate favourable interest rates or loan terms.
- vii. **Innovative Businesses:** Innovative companies heavily reliant on their IP portfolio can use IP-based financing to fuel research, development, and expansion initiatives.
- viii. **Market Expansion:** Funding secured using IP collateral can be used to enter new markets or develop new products and services associated

with the IP.

- ix. **Preserving Equity:** By using IP as collateral, businesses can avoid giving up equity in exchange for funding. This can help maintain ownership and control over the company's growth trajectory.
- x. **Asset Monetisation:** For established companies with valuable IP assets, using IP as collateral can provide a way to monetize these assets without having to sell them outright.
- xi. **Risk Sharing:** Lenders, if confident in the value and protection of the IP, may be more willing to share the risk associated with the loan.

Despite these benefits, using IP as collateral also has its challenges. Valuing IP accurately can be complex, and lenders may require additional due diligence and legal documentation. If the borrower defaults on the loan, there might be challenges in selling or monetizing the IP collateral.

RECOMMENDATION

Given the dearth of this form of collateral in our jurisprudence, the following solutions should be utilised by relevant actors to create a viable environment for IP securitisation in Nigeria.

- I. **Registering your IP:** Ideas do not have IP rights and do not become assets until registered as appropriate. This gives exclusive rights that may later be utilized as collateral for loans and grants the ability to launch legal proceedings against infringers.
- ii. **Enlightenment:** Legislation, awareness and sensitization campaigns by agencies such as the National Copyright Commission,

⁵ Ibid

⁶ Ibid

⁷ M. Popoola, 'Lending Securities: Building a Case for Intellectual Property Assets in Nigeria' <<https://www.linkedin.com/pulse/lending-securities-building-case-intellectual-property-popoola/>> accessed 8 August, 2023.

Trademarks Registry, the Patent Offices, among others and IP sector participants, should increase public understanding of and familiarity with national IP laws.

iii. Legal Framework: Legal recognition of IP assets as collateral and the framework for IP securitization will both significantly increase the use of IP financing in Nigeria. Although the assignment and licensing of IP Rights are recognized under the present IP framework, more has to be done to make IP Financing easier. An example is the Kenyan Movable Property Security Rights Act of 2017, which enables Startups and companies to acquire finance by securitizing intellectual property assets. See also as earlier mentioned, Section 222 of the CAMA.

iv. Contract: To safeguard the borrower, the terms of the loan facility agreement must be documented. Clarity of terms would enable parties to manage obligations and follow-up to ensure performance. Key points for discussions and agreement include, but are not limited to, exploitation of the IPRs, status of new IP assets created, ownership rights to determine in whose name the IPRs are registered, events of default, and enforcement of the security.

CONCLUSION

IP securitization as a funding mechanism in Nigeria will remain a theoretical concept until we take purposeful actions to make it a reality. IP registries such as the Trademarks, Patents, and Designs Registry, should do more to promote IP and its value by constantly engaging the public through seminars, workshops, and trainings. These registries should develop a framework that allows the protection of the lender's interest in the IP from third-party infringement.

To effectively benefit from IP securitization, the judiciary needs to play a key role. Due to the intangible nature of the property, infringement may occur without the awareness of the owner; nonetheless, once aware, the owner should be able to file a claim and trust in prompt resolution. Investors need the assurance that the use of IP as security can be protected by our Courts.

Finally, before using IP as collateral for funding, it is highly recommended to consult with legal and financial experts to assess the specific circumstances, the strength of the IP, and the potential benefits and risks for your business.

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