Nandan Pendsey

Nandan Pendsey is currently a Partner with AZB & Partners and heads the IP practice at its Mumbai office. He earned his B.S.L. LL. B Degree at the prestigious ILS Law College, Pune in 2001 and further earned his Master’s Degree (LL.M) in Intellectual Property from the Franklin Pierce Law Center, New Hampshire, USA in 2003.

The focal areas of his practice are intellectual property litigation, enforcement and advisory, client counselling, patent and trademark prosecution, intellectual property transactions and licensing. Nandan also regularly provides advice on regulatory issues arising in relation to drugs, cosmetics, medical devices and clinical trials. He has extensive knowledge in the areas of information technology, data privacy, outsourcing, cyber law, registration, protection and enforcement of domain names, and other internet related issues including jurisdictional and enforcement issues and ISP liability.

Memberships & Affiliations:

1. Registered to practice in India, State of New York and the State of California
2. INTA (International Trademark Association)
3. LESI (Licensing Executive Society International)

Kirti Balasubramanium

Kirti Balasubramanian is currently an associate in the Intellectual Property team at AZB & Partners, Mumbai. She has worked extensively on matters involving enforcement of intellectual property rights. She began her career as a litigator practicing at the Courts at Delhi with a top tier IP boutique firm. She has received a B.Sc. Degree in Mechanical Engineering from Drexel University, Philadelphia and an LL.B. from ILS Law College, Pune in 2012.

Aparajita Lath

Aparajita Lath is an associate with AZB & Partners. She received B.A.LL.B. (Hons.) from the West Bengal National University of Juridical Sciences in 2015 and began her career at AZB & Partners in the same year. Her primary practice areas include intellectual property rights, commercial dispute resolution, mergers and acquisitions and general corporate law. She has contributed to publications on intellectual property developments in India and has a keen interest in the emerging issues in this field.
While traditional lending in India continues to rely upon securities created over tangible assets such as immoveable property, shares and machinery (typically the most valuable assets of a borrower), it is no secret that intangible assets such as intellectual property (IP) rights are increasingly becoming critical and contribute as much to businesses and their offerings.

This has also been given due credence by the Government of India, which introduced the National IPR Policy (IP Policy) in May 2016 outlining the “roadmap for the future of IPRS in India”. One of the stated objectives of the IP Policy is to “enable valuation of IP rights as intangible assets by application of appropriate methodologies and guidelines; facilitating securitization of IP rights and their use as collateral by creation of enabling legislative, administrative and market framework”. The Policy recognizes that the economic value of IP rights must be fully unlocked through commercialization, which in turn, is likely to become a key driver of innovation in India and account for a fair share of her economic growth.

In this article, we will first briefly set out the types of IP recognized in India (either by statute or common law) which can be securitized, the existing legal framework governing the creation of security interest over IP and then, examine the complexities arising out of the inherent nature of these intangible assets that should be kept in mind by lenders during such transactions. Finally, we will discuss some key considerations from a transactional perspective.

**Types of Intellectual Property**

The term ‘intellectual property’ includes a variety of intangible rights and comprises of the following in respect of which security interests can be created:

(i) Traditional forms of intellectual property such as patents, trademarks, copyrights and designs - Patents are a 20-year exclusive right given to a patentee for an 'invention' that fulfills the requisite patentability criteria. Copyrights are also time limited exclusionary rights given to certain 'works' such as literary, dramatic, musical, artistic works, cinematographic films and sound recordings. Trademark law provides statutory and common law protection to source identifiers such as names and logos of a business or its products / services, for an indefinite period (unless the trademark is challenged by a competitor, abandoned or removed from the register). Design rights (or copyrights in design) are conferred on industrial designs for a maximum period of 15 years.

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1. India, Ministry of Commerce and Industry, Department of Industrial Policy & Promotion. 12 May 2016. dipp.nic.in/sites/default/files/National_IPR_Policy_English.pdf
2. Ibid
As per the Companies Act, 2013, a company may create a charge “on its property or assets or any of its undertakings, whether tangible or otherwise, and situated in or outside India”. Intangible assets include intellectual property rights and goodwill. The creation of a charge, whether fixed or floating, is therefore permitted on IP and goodwill. This charge is required to be registered with the Registrar of Companies.

Similarly, under the SARFAESI Act, which deals with creation of security during the time of debt restructuring, ‘security interest’ is defined to mean any ‘right, title and interest of any kind whatsoever upon property, created in favor of any secured creditor and includes any mortgage, charge, hypothecation, assignment other than those specified in Section 31 of that Act.’ The term ‘property’ is defined to include various intellectual property rights and intangible assets.

As is evident, the term ‘intellectual property’ encompasses a variety of proprietary, exclusionary rights whose boundaries are continuously expanding to accommodate new types of knowledge & innovation. However, in India & abroad, only a handful of IP rights, such as future receivables on licensing of musical works, trademarks & patents have been used as a security.

The relevant Indian enactments which enable us to assess whether security interest over IP can be created are:

(i) General laws such as the Companies Act, 2013 and the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (“SARFAESI Act”); and

(ii) Special laws such as the Patents Act, 1970, Designs Act, 2000, Trade Marks Act, 1999 and Copyright Act, 1957.

General Law

The Patents Act, 1970 and the Designs Act, 2000 contemplate the recordal of security interest created by way of an assignment, license, mortgage or otherwise. These enactments mandate that the creation of security interest over the patent / design should be recorded in writing and communicated to the Controller of Patents / Designs.

(ii) Sui generis forms of intellectual property such as plant breeder’s rights and semiconductor integrated circuit layout rights etc.;

(iii) Common law rights in respect of intellectual property which have been recognized through judicial precedent such as trade secrets, confidential information and goodwill etc.

Legal Framework

The relevant Indian enactments which enable us to assess whether security interest over IP can be created are:

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(ii) Special laws such as the Patents Act, 1970, Designs Act, 2000, Trade Marks Act, 1999 and Copyright Act, 1957.

Special Law

The Patents Act, 1970 and the Designs Act, 2000 contemplate the recordal of security interest created by way of an assignment, license, mortgage or otherwise. These enactments mandate that the creation of security interest over the patent / design should be recorded in writing and communicated to the Controller of Patents / Designs.

4. Section 2(1)(zi), SARFAESI Act.
5. Section 2(1)(t)(v), SARFAESI Act states that “property” means - intangible assets, being know-how, patent, copyright, trade mark, license, franchise or any other business or commercial right of similar nature;
On the other hand, the Trade Marks Act, 1999 and the Copyright Act, 1957 are silent on the creation or recordal of security interest over trademarks / copyrights. These enactments, however, contain provisions pertaining to the assignment of rights in registered or unregistered trademarks or copyrights; and require that such assignment must be in writing. Copyrights, being a bundle of rights, can be assigned in whole or in part, for the entire term or a portion of it. Therefore, security interest in respect of these types of IP may be created by way of assignments but are not restricted to the same.

**Key Features of IP**

IP has certain unique features as an asset class, as detailed below, which lenders should be mindful of, when creating security interest over IP:

**Intangible:** It is needless to say that unlike traditional assets which are tangible, IP is an intangible asset. This nature of IP dictates the choice of security interest that may be created over it. Security interests that require transfer of possession from the owner (borrower) to the lender such as a pledge is not suited for IP. Even in the case of registrable IP, that is, patents, designs, trademarks and copyright, the transfer of the certificate of registration in relation to that IP will not constitute transfer of possession of the IP. The IP will continue to vest with the owner (security provider) until the ownership is actually assigned to the lender on enforcement. However, security interest created by hypothecation wherein a charge attaches to the asset without the requirement of transfer of possession or title is one of the more common forms of security for IP financing.\(^8\)

**Operational:** Irrespective of the type of security interest created over IP, it is in the lender’s interest that the IP remains operational and is worked, maintained and enforced to keep its value intact as far as possible.\(^9\) Although the lender has the option to do so himself (once IP is assigned by the owner), in most cases, such lender would be ill-suited to handle such responsibility. In view of this, any security interest created by a transfer in title from the owner to the lender may be unsuitable for IP. Lenders may work around this limitation by licensing the rights back to the owner for business continuity and use. It is, however, pertinent to note that IP statutes in India do not allow mere licensees, who are not exclusive licensees (or registered users in respect of trademarks) to initiate enforcement proceedings. Moreover, even in cases where such exclusive licensee / registered user is permitted to initiate such an enforcement action, he may be compulsorily required (depending on the type of IP) to implead the owner as a co-plaintiff or a proforma defendant in such proceedings before courts.\(^10\) Lenders may not be keen on such involvement.

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9. Ibid.
10. See supra note 8.
12. For instance, Section 52 of the Trade Marks Act, 1999 states that “(1) . . . a registered user may institute proceedings for infringement in his own name as if he were the registered proprietor making the registered proprietor a defendant and the rights and obligations of such registered user in such case being concurrent with those of the registered proprietor (2) . . . a registered proprietor so added as defendant shall not be liable for any cost unless he enters an appearance and takes part in the proceedings.”
**Time-Limited:** All types of IP have limited periods of validity (except for trademarks which are required to be renewed every 10 years in India or trade secrets, which can last indefinitely). Lenders must therefore be aware of the limits on both the duration of validity of the relevant IP and its commercial shelf life. For instance, IP such as computer software, though valuable, typically have a limited commercial shelf life. Lenders must therefore ensure that both the legal and commercial life, which affect the value of the IP, predictably matches the financing term.

**Legal Validity:** The statutory term of an IP can be limited further due to invalidity actions initiated by third parties. Unlike most tangible property rights, the property rights / validity of an intellectual property right may be challenged at any point in time. For instance, even if a patent has been granted, as there is no presumption of validity attached to a granted patent, it remains vulnerable to post-grant challenges by third parties throughout its term. Also, though a trademark may be protected indefinitely, it may not be advisable for lenders to accept unregistered trademarks as security due to the uncertainties associated with their enforcement against third parties.

**Value and Rating:** A major limitation to creating security interest over IP is the problem faced in relation to the valuation of IP and a fair assessment of its importance to the business of the owner. Various factors influence the valuation of different types of IP. For instance, in case of copyrights, the copyright owner’s rights to exclude others and prevent reproduction of his work (that is, the exclusivity which is responsible for the commercial value of the work) may be severely curtailed through fair use of such copyrights by third parties, in activities (private research, education) that are permitted by the statute itself. Parallel importation of products embodying the IP of a company may also undercut the commercial value of the IP in the market; whereas in the case of pharmaceutical patents, the possibility of compulsory licensing by the Patent Office can weigh as a drain on the monetary value that can extracted from the IP over the term of the security. Furthermore, lenders should also be aware that certain types of works embodying various IP such as computer software, database, algorithms, user interfaces etc. are weaker IP rights and risks being easily reverse engineered, drastically reducing their ability to retain their commercial value for any significant period. Lenders should therefore seek legal and commercial advice on the likelihood of any of these events which may affect the valuation of the said IP.

**Jurisdiction:** Lenders must bear in mind that most IP rights are territorial in nature. For instance, a patent granted in the US will not be valid in India unless it has been separately applied for and granted by the Indian Patent Office. Similarly, trademarks and designs protection are also jurisdiction specific. Given that business activities are increasingly crossing borders, lenders should be aware that the value of IP may reduce if a competitor is able to obtain protection in other jurisdictions.

**Value on default:** IP assets are often seen as ‘passive assets’ where the company holding the IP uses its exclusionary rights primarily to prevent unauthorized competition.\(^{16}\) Active use of IP is limited to situations where a business licenses its IP to others in the market. On the other hand, other tangible assets owned by the company, such as buildings, plant, machinery, stock, book debts etc. are seen as ‘active property’ as they are inherently useful and can be directly used by the company itself for business growth. Therefore, in the event of default, the lender must assess its use of the said IP and possibility of sale, if any.\(^{17}\) It must be borne in mind that IP may be best utilized by the developer of the IP itself especially if the lender is not in the same industry as the borrower. Commercial advice should therefore be obtained in this regard.

**Other Considerations**

Other factors (IP related) to be accounted for when crystallizing the contractual arrangement for creating a security interests are as follows:

(i) Assessing how critical the IP in question is for the business of the borrower. For instance, the borrower’s trademarks and patents may be more valuable than its copyrights. Further, if exploitation of IP is an essential part of the borrower’s (owner of the IP) business, then a charge may be created over the royalty stream arising out of the exploitation of IP.\(^{18}\)

(ii) Lender must obtain appropriate warranties from the security provider with respect to title to the IP, its validity & enforceability, no pre-existing charges or any other restrictions on transfer of IP. This is especially critical in the absence of accessible registers for copyrights & designs.

(iii) Lender should ensure that the description of the IP includes all associated and neighboring rights and interests. For instance, if trademarks are the IP, all associated goodwill and revenue streams from existing licensing arrangements etc. should also be included in the definition of IP.

(iv) The lender should ensure that the borrower preserves the IP in question effectively for the term of the loan. In this regard, the borrower must not only ensure that the renewal fees and other procedural requirements under the various IP legislations are fulfilled, but that requisite enforcement actions are taken against third party infringers.

(v) Deterioration in value of the IP could be a trigger for an event of default, just like the deterioration of any other tangible security. The critical challenge here would of course be the lender and borrower agreeing on the method of valuing the IP. A valuable lesson in this regard was taught recently by the failed auction of the trademarks of Kingfisher Airlines,\(^{19}\) wherein lenders suffered from the devaluation of the brand over a short period of 3 years.

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\(^{17}\) Ibid

\(^{18}\) See Abraham, Matthew, Barrister. “Tapping the Intangible: Security Interests and Intellectual Property.” Insolvency Intelligence, 2013, 26(8), 113

Conclusion

The peculiar nature of IP along with the specific legislations governing its protection, maintenance and enforcement in India give rise to a unique set of issues in the creation of security interest over IP rights. Perfecting a security interest is also critical and requires recordals spanning several Government agencies or registries (such as the Registrar of Companies and the specialized IP registries). Therefore, to make IP a more viable asset class for creating a security interest, it is imperative that lenders have a nuanced understanding of the features of this asset class, the law governing the specific intellectual property right, legal compliances required to perfect the security interest as well as key principles impacting its valuation.