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In Practice

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Intangible assets and the Loan Market Association forms of documents

The Loan Market Association form of facilities agreement for leveraged acquisition finance transactions contains provisions relating to intellectual property rights but it assumes that these rights may not be fundamental. In this In Practice article Charles Kerrigan considers the questions lawyers should be asking where intangible assets are significant in a proposed borrower group.

Intangible assets are obviously of increasing importance in the world economy. Studies by the UK Intellectual Property Office show that investment in intangible assets has exceeded investment in tangible assets in every year since the mid-2000s. A 2017 study in the US by Ocean Tomo LLC found that intangible assets comprised 84% of the 2015 market capitalisation of the S&P 500.

This trend will continue and accelerate as a result of business "digital transformation" plans and the emergence of new businesses. A 2018 Accenture study found 48% of global companies "highly susceptible" to digital disruption. As a consequence, funders find and will find that their borrowers have correspondingly fewer tangible assets to offer as security collateral, that borrowers are more reliant on revenues earned from the exploitation of intangible assets and that intangible assets comprise an increasing amount of security collateral in funding transactions. Funders also, rightly, consider that intangible assets may be more difficult to value and enforce against in a distress situation. Added to this is a conceptual tension between intangible assets and security. Where intangible assets are represented by intellectual property rights (IPR), these rights confer for a time a monopoly right on the holder. In other words, the law rewards the developer of novel intellectual property by providing a period during which the developer has exclusive rights to the economic fruits of this property. So, the developer is incentivised to exploit those rights. On the other hand, security interests are characterised by control in the hands of the security holder. Security holders must, however, recognise that borrower groups need to control their IPR in order to exploit it. This may make fixed charge security difficult, but it follows of necessity from the nature of IPR.

The Loan Market Association form of facilities agreement for leveraged acquisition finance transactions (the LMA document) contains provisions relating to IPR. It defines "Intellectual Property" broadly and it includes representations and positive and negative undertakings which cover ownership, maintenance, registrations, preservation of value and prevention of infringement.

The LMA document assumes that a business has IPR but that these may not be fundamental. Where intangible assets are significant in a proposed borrower group a more bespoke approach is useful. The point can be illustrated by asking questions, such as those set out below.

- **Is the definition of Intellectual Property wide enough?** The LMA document definition of intellectual property lists the main categories of UK IPR and includes applications and rights of use as well as the IPR themselves. A definition of intangible assets would be wider. For example, the Big Innovation Centre offers this definition (of which IPR are a part): "… computerized information, data, software, intellectual property, science, economic competencies, business processes and more …". The loan agreement should in some way cover all assets relevant to the business and the clauses referenced below should be extended accordingly.
- **Are the assets identified, recorded etc?** The LMA document does not require the borrower to provide information on its intangible assets. For a business where significant value is comprised in these assets it is necessary for funders to include in the document a requirement for the borrower to produce an asset register identifying intangible assets including IPR together with information on recordals, registrations and valuations. The frequency with which this information should be updated is dependent on the nature of the assets. Copyrights are produced more often than patents, for example. Valuations also need to distinguish between value to the business as a going concern and standalone value. The value of IPR in brand is an example of value which is not likely to survive a failure of the business.
- **What should the loan agreement be testing?** Each case is different but the general considerations in identifying a critical IPR or other intangible asset are whether it is commercialised, has revenues attributable to it (directly or indirectly), is profitable, has defensive value in preventing competitors from entering a market, is (or will be) used in the business or business processes, supports the brand etc. Other points will be apparent from the business model, financial statements and projections. In this article, value and related terms are used in their widest sense to mean economic, strategic, brand and other value.
- **Is it possible to comply with undertakings?** Some IP lawyers take the view that, because IPR by their nature do not have well-defined edges, it is not appropriate to apply generic undertakings to them. For example, an undertaking not to infringe misses the point that an IP lawyer would be looking at the likelihood of a successful infringement action and this is not simply a question of fact.
- **Is it commercially right to comply?** Not all IPR are valuable. For example, only a minority of existing patents have value. It is not commercially sensible to impose generally applicable obligations requiring a business to prevent these from lapsing.
- **How should transactions be treated?** The LMA document restricts disposals (other than Permitted Disposals, although the permission for IPR is somewhat ambiguous) and exploitation of IPR often involves disposals. Broadly, where IPR are licensed this may be on an exclusive or non-exclusive basis. An exclusive licence is likely to be a capital transaction, in other words it will raise proceeds equivalent to the value of the IPR and the licensor will no longer have the use of the IPR. A non-exclusive licence is likely to be an income transaction, in other words it will produce an income stream of less than the value of the asset and the licensor will retain the ability to further exploit the asset. It is useful to make this distinction not only in terms of the negative undertaking and permission but also because the distinction may

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have implications elsewhere in the document. For example, should an exclusive licence trigger a mandatory payment obligation?

- **Are the qualifications right?** It is common for borrowers to request qualifications in documents, for example testing only IPR which are "necessary for the business" or tests triggered only by a "material adverse effect". This may not be appropriate. A "necessary" test would not, for example, catch valuable IPR which are not currently used or IPR in development but not yet included in products. A material adverse effect test in relation to intangible assets is usually impossible to judge except where there are revenues directly attributable to the particular assets.
- **How should value be defined?** The LMA document imposes a restriction on actions which would affect the economic value of IPR. The subject of economic valuations in relation to intangible assets is not easy. Valuations may be qualitative or quantitative, including cost-based, market-based, income-based and option-based. Methodology should be consistent in relation to specific assets but not necessarily the same for all assets. Where funders place reliance on particular assets, specific terms relating to their valuation and use should be included in the document.
- **How much value is in contracts and licences?** Contracts and licences are valuable because of the rights they grant and/or the revenues they generate. They are not directly referenced in the definition of Intellectual Property in the LMA document. If they are included in a funder's credit decision they should be dealt with specifically in the loan agreement. The termination provisions in contracts and licences must be studied to enable scenario planning on enforcement to be completed. Some funders have a policy only to fund IPR and not other intangible rights including licences or contracts. (It is one of the ironies of this subject that assets which best suit traditional cashflow lending models suffer from objections based on the terms of the cashflows.)
- **Can third parties provide support for the transaction?** Clearly, it is possible to manage some of the risks associated with contracts and licences by working with the counterparties and using notices and acknowledgements, letters of direction, direct agreements and similar. In principle this is fine. In practice, account must be taken of the willingness of different types of counterparty to co-operate. There is not much to be gained from asking large software vendors or statutory bodies to amend their terms. Related parties, downstream licensees and service providers are more flexible. Funders should be aware of the relevant market practice before starting a transaction.
- **Are amendments required to the insurance undertaking?** An LMA document undertaking requiring a business to maintain insurances which are "usual" for similar businesses is difficult to apply in industries where there is not settled practice in relation to insurance protecting intangible assets. Insurance is available to cover the costs of litigation relating to IPR, for mis-valuation of IPR, for damage to a brand, for losses from cyber incidents and others. The options are multiplying. The funders' requirements should be set out.
- **Are funders protected from losses resulting from reputational damage to a borrower's business?** IT failure, a hack, an unpopular change to a product, a public mis-step or mishandled PR can all be catastrophic for a funder. Risks are heightened in businesses with centralised IT functions, a narrow product line, a homogenous customer base, a lot of value in its brand, large amounts of retail customer data or a dominant CEO. This will become more significant for funders because it will become more significant for their borrowers. Experts note that computers and networks are not secure because consumers prefer to pay for features they can see. The internet of things is about to make the issue much more acute. The new Californian internet of things security law suggests regulation will mitigate commercial risk but add in its place some regulatory risk. These points cannot be addressed through undertakings in loan agreements. They relate to the nature and culture of a business. Funders should know their risk and their borrowers.
- **Does the loan agreement need to deal with emerging technologies?** In the community there is a saying that there are three types of businesses: tech businesses, tech-enabled businesses and businesses with an uncertain future. The first two types are making major investments in emerging technologies, such as artificial intelligence and blockchain-type technologies. There are a number of issues associated with emerging technologies relevant to funders. Some are commercial. For example, in some loans the amount of investment in developing technology is limited by reference to revenues derived from existing business. Others are technical. AI and blockchain-type technologies often build on or run on software owned by third party vendors or on open source software. Generally, this area is growing fast but requires care and approaches are likely to change at short notice.
- **Enforcement review**: As noted in other articles on this subject it is important to have a document summarising the enforcement options and strategy at the time the funders commit to fund a loan. Enforcement in relation to intangible assets is complex and enforcement action can prejudice valuable rights such that work-outs rather than insolvency processes are most common. Most funded transactions involving intangible assets are secured and involve corporate entities as borrowers. Therefore, security is given by a corporate and registered at UK Companies House and at the relevant IP registry. The Companies House regime is focused on the grantor of the security. The IP registry regimes are focused on the asset. The regimes are not harmonised and can involve circularity unless care is taken.
- **The context under English law**. English law provides a framework for the recognition of intangible assets but not of every class referenced in this article. It does not formally recognise a "digital asset". Information is not property under English law (*Your Response v Datastream Business Media* [2014]). It is not certain how tracing and similar remedies should apply to intangible assets. There are questions about whether remedies in decentralised systems should be through the courts or through the code. There is no consistent international position on how cryptocurrencies should be classified, whether money, commodities, securities or *sui generis*. Where businesses are adopting tokenisation models these are governed by their own terms and conditions but are not either equity or debt and so characteristics which are features of these under statute (such as anti-dilution protections) are not available unless written into the terms and conditions. ■