

Utilising IP as Security for Financing in South Africa

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Abstract.

Companies or Small Medium Enterprises (SMEs) have the ability to raise funding for their objects either by selling their shares or through direct debt finance which means approaching banks or financial institutions for external financing. These financial institutions or individual creditors such as moneylenders, in order to mitigate their own risk, would typically require some form of security or collateral which could be in form of valuable tangibles such as land, buildings or intangibles such as stocks, shares and intellectual property (IP). This paper examines the nature and classification of IP and the various ways security interests could be created over various forms of IP in South Africa. It examines the various challenges that could be faced in the utilisation of IP as security especially with regards valuation and it recommends possible ways to enhance the utility of the value of IP through securitisation.

Keywords: Intellectual Property, Security, Financing

1. Nature and Classification of Intellectual Property

Security can be created over tangible and intangible property, security as a concept can be divided into real and personal security, a real security gives the creditor a limited real right in property whether movable or immovable that belongs to the debtor while personal security gives the creditor a personal right against a third party who undertakes personally to settle the debt of the debtor where the debtor fails to do so.¹

IP are creative works which reward creators with exclusive rights which often yield economic value, the purpose is to provide an incentive for these creators to innovate more. IP are intangible assets which are ‘non-monetary assets which are not identifiable and without physical substance’ (either being separable or arising from contractual or other legal rights).² IP can be defined as

A category of intangible rights protecting commercially viable products of the human intellect. The category comprises primarily trademark, copy-

¹ H Mostert, A Pope and PJ Badenhorst, *The Principles of the Law of Property in South Africa* 1st ed (2010) at 356.

² International Accounting Standards ‘IAS 38 — Intangible Assets’ available at <https://www.iasplus.com/en/standards/ias/ias38> accessed on 17 September 2021.

right and patent rights, but also includes trade-secret rights, publicity rights, moral rights and rights against unfair competition.³

The value of IP cannot be overemphasised, for instance, the top 100 brands in the world in 2021 account for a worth of \$ 7.1 trillion which is equivalent to the combined GDP of France and Germany, the top three brands Amazon, Apple and Google are worth \$684 million, \$612 million and \$458 million respectively.⁴ IP securitization is quite common in music and film industry for instance David Bowie in 1997 issued 10-year asset-backed bonds on the basis of future royalties on publishing rights and master recordings from 25 pre-recorded albums, and raised US\$55 million. The purchaser of the bonds gained the right to receive future royalties from Bowie's albums until the principal plus 8% annual interest was repaid.⁵

IP whether copyright,⁶ patents,⁷ trademarks,⁸ designs,⁹ or plants breeders' rights¹⁰ are of incorporeal nature which means they are 'incapable of being touched, being perceived by other senses or occupying physical space',¹¹ they are essentially intangible in nature and may be enjoyed by an indefinite number of subjects simultaneously, for instance a copyright holder does not lose the ability to reproduce a work because another person has done so.¹²

It is therefore generally accepted that IP are of incorporeal nature and not corporeal for instance trademarks, copyright, designs and patents have been classified as moveable incorporeal property.¹³ The UNCITRAL Legislative Guide on Secured Transactions¹⁴ classifies IP

³ BA Garner and HC Black '*Black's Law Dictionary*' 9th Edition (2009) at 960.

⁴ Nathalie Burdet 'What are the most valuable global brands in 2021?' available at <https://www.kantar.com/inspiration/brands/what-are-the-most-valuable-global-brands-in-2021> accessed on 17 September 2022.

⁵ WIPO 'Intellectual Property Financing- An Introduction' available at https://www.wipo.int/wipo_magazine/en/2008/05/article_0001.html accessed on 17 September 2022.

⁶ Copyright Act 98 of 1978.

⁷ Patents Act 57 of 1978.

⁸ Trademarks 194 of 1993.

⁹ Designs Act 195 of 1993.

¹⁰ Plants Breeders' Rights Act 15 of 1976.

¹¹ PJ Badenhorst, JM Pienaar and H Mostert, *The Law of Property* 5th ed (2006) at 33.

¹² A Tosato 'Security Interests over intellectual property rights' (2011) 6 *Journal of Intellectual Property Law & Practice* 93 at 95.

¹³ CG van der Merwe and MJ de Waal, *The Law of Things and Servitudes* 1 ed (1993) at 27.

¹⁴ UNCITRAL Legislative Guide on Secured Transactions: Supplement on Security Rights in Intellectual Property (2010).

as moveable security, the Copyright Act¹⁵ also expressly recognises that copyright can be transmissible as moveable property,¹⁶ this is one of the reasons why the court's decision in *Gallo Africa Ltd and others v Sting Music Ltd and others*¹⁷ generated a lot of comments and certainly raised eyebrows.

In *Gallo Africa*, the court in assessing whether IP is a moveable or immovable property, held that the territoriality of IPRs is enough to infer that IP assets are immovable intangibles.¹⁸ Commentators like Visser disagreed with this view and remarked that it appears the decision was hastily made,¹⁹ this paper aligns itself with Visser's view and further submits that IP is a moveable intangible which is evident in s 22(5) of the Copyright Act and it appears the court proceeded on a mistaken notion that IPRs vest exclusive jurisdiction while ignoring the extraterritorial aspects of IP which is evident in the national treatment obligation as provided in the Berne convention.

2. Intellectual Property as Security for Financing

Security interest over IP is often created through hypothecation. Hypothecation is when an asset is pledged as collateral for loan,²⁰ a pledge is created by agreement between the pledgor who undertakes to repay or fulfil an obligation and the pledgee who undertakes to subsequently deliver the relevant property.²¹

The four aspects of a pledge which are namely; its accessory nature, the pledge agreement, the type of property pledged, and the vesting of the legal control of the pledged property in the pledgee which is satisfied by the endorsement of the hypothecation in the register.²²

A pledge is of accessory nature because it is being used as security for fulfilment of an obligation to repay a loan.²³ A pledge agreement creates personal rights and obligations which if given effect to, results in

¹⁵ Section 22(5) of the Copyright Act

¹⁶ S Karjiker 'Intellectual Property as Real Security' (2018) 6 *South African Intellectual Property Law Journal* 1 at 8.

¹⁷ *Gallo Africa Ltd and others v Sting Music Ltd and others* (2011) 1 All SA 449

¹⁸ *Gallo Africa Ltd v Sting Music Ltd* supra (n17) at para 19.

¹⁹ C Visser 'Jurisdiction in Respect of Claims of Extraterritorial Copyright Infringement: *Gallo Africa v Sting Music* (2011) 23 *SA Merc LJ* 529 at 531.

²⁰ Investopedia 'Hypothecation' available at <https://www.investopedia.com/terms/h/hypothecation.asp> accessed on 29 September 2022.

²¹ E de la Rey, M Roestoff *et al* Mars: *The Law of Insolvency in South Africa* 10th ed (2019) at 483.

²² Ibid.

²³ Karjiker op cit (n16) at 9.

a pledge because it evidences circumstances which the pledgor would be deemed to have breached imposed obligations.²⁴ A pledge can be created over incorporeal moveable property by means of security cession though a pledge agreement may be created over property yet to come into existence, the actual pledge only comes into existence when the future property does.²⁵ Legal control can be taken through possession over a pledged property however due to incorporeal nature of IP, legal control can be taken through the endorsement of the hypothecation in the register which results in the publicity of the security arrangement.²⁶

It is important to note that due to the incorporeal nature of IP, the general rules of pledge as a moveable property must be subject to the hypothecation provisions of the relevant IP legislations i.e. Trademarks Act.

2.1. PATENTS AND DESIGNS

The Patents Act expressly allows the creation of security interest over patents, it provides that hypothecation of a patent or an application for a patent may on application be entered into the register.²⁷ The Designs Act also allows hypothecation of a registered design or an application for a design which may on application be entered into the register.²⁸ The patent or design owner does not give up title or ownership rights, though the patent or design owner or applicant would be unable to alienate, encumber or license the hypothecated patent or design upon entry of the hypothecation in the register.²⁹ The Designs Act however expressly provides that the prohibition is not absolute and won't apply to compulsory licenses,³⁰ while the Patents Act is silent on this, it has been submitted that the encumbrance on hypothecated patents will not apply to compulsory licenses since they are not granted by the patent holder.³¹

A major challenge to the utilisation of patents and designs as security is that they are subject to a term limit for protection,³² thus the lender would have to take cognisance of the fact that the asset might fall into public domain making it available for use by all and it is possible

²⁴ Ibid.

²⁵ Ibid.

²⁶ Ibid.

²⁷ Section 60(5) of the Patents Act.

²⁸ Section 30(5) of the Designs Act.

²⁹ Section 60(6) of the Patents Act and Section 30(6) of the Designs Act.

³⁰ Section 21 of the Designs Act.

³¹ Karjiker op cit (n16) at 11.

³² Section 46 of the Patents Act and Section 22 of the Designs Act.

that the registered patent or design may be expunged from register for not fulfilling certain requirements i.e. Novelty, inventiveness.³³

2.2. TRADEMARKS

The Trademarks Act provides that a trademark may be hypothecated by a deed of security,³⁴ and where such deed of security is lodged with the registrar who shall endorse the register with the name and address of the person in whose favour the hypothecation has been created.³⁵ The Trademarks Act also provides that an endorsement in the register will have the effect of a pledge of the trademark to the person in whose favour the deed of security has been created.³⁶

The express consent of the holder of the security is required before a hypothecated trade mark can be assigned which essentially gives said holder legal control over the trade mark.³⁷ There is however an absence of statutory prohibition of licensing in trademarks which can be found with the hypothecation of patents and designs, it has been submitted that this restriction could be imposed contractually by the parties.³⁸

2.3. COPYRIGHT AND PLANT BREEDERS' RIGHTS

Copyright as discussed above is transmissible as moveable property, however unlike other primary IP legislations, the Copyright Act and the Plants Breeders' Act did not provide for the hypothecation of copyright and plants breeders' rights. Karjiker submitted that where there is no provision for statutory hypothecation in the legislation, other forms of security over IP become relevant such as security cession and notarial bonds become relevant.³⁹

Security cession is 'where a debtor cedes (transfers) to a creditor certain incorporeal personal rights to secure the repayment of a debt (the "Principal Debt")'.⁴⁰ No formal requirements are required for the cession although parties may agree on terms which must be complied, thus they may be express or implied from the conduct of the parties.⁴¹

³³ N Locke 'The Use of Intellectual Property as Security' (2004) 16 *South African Mercantile Law Journal* 716 at 721.

³⁴ Section 41(1) of the Trademarks Act.

³⁵ Section 41(3) of the Trademarks Act.

³⁶ Section 41(4) of the Trademarks Act.

³⁷ Section 41(5) of the Trademarks Act.

³⁸ Karjiker op cit (n16) at 10.

³⁹ Karjiker op cit (n16) at 13.

⁴⁰ M Kotze 'Security cession – Important considerations' 23 June 2020 available at <https://www.golegal.co.za/security-cession-debt/> accessed on 3 October 2022.

⁴¹ Ibid.

A security cession could be structured in two forms, it could be ‘the outright cession of rights with an undertaking that the cessionary will restore the rights to the cedent on the satisfaction of the secured debt’,⁴² the implication of this is that the cedent bears more risk than the cessionary.

The second form of a security cession is where the rights of the cedent are pledged to the cessionary though the cedent retains ownership hence the pledge construction.⁴³ This is more desirable than the former arrangement.

Scott argued that while cession might be applicable to incorporeal rights such as the right to claim a particular performance, its use should not extend to incorporeal rights such as IPRs which would be tantamount to transfer of these IPRs.⁴⁴ Scott’s position is backed partly by Karjiker who opined that the various IP legislations already provide for a specific form of transfer for example copyright provides for assignment.⁴⁵ He however disagrees with Scott’s position that cession should not be applicable to IPRs, he stated that the assignment contemplated in the Copyright Act was derived from the s 5(2) of the British Copyright Act of 1911 which states that copyright may be transferred by assignment, he submitted that the South African equivalent of the English concept of assignment is cession since assignment under the South African law applies to transfer of rights and obligations as is the case with cession.⁴⁶

A notarial bond is a formal document containing the agreement by which a debtor agrees to hypothecate movable property in favour of its creditor (or bondholder) as security for the repayment of a debt.⁴⁷ Notarial bonds are divided into general and specific bonds, and they may be created over corporeal and incorporeal moveable property.⁴⁸

Notarial bonds unlike security cession must be registered in accordance with a registration system administered by the Deeds Registries Act.⁴⁹

3. Challenges in the Utilisation of IP as Security

Most banks and financial institutions unsurprisingly are often reluctant to accept IP despite its value as security or collateral for a loan by a

⁴² Ibid.

⁴³ Ibid.

⁴⁴ S Scott *The Law of Cession* 2 ed (1991) at 22.

⁴⁵ Karjiker op cit (n16) at 16.

⁴⁶ Karjiker op cit (n16) at 17.

⁴⁷ Ibid.

⁴⁸ Ibid.

⁴⁹ Deeds Registries Act 47 of 1937.

business or SME. This is due to some of the challenges that may be faced in holding security interest in IP.

(a) Difficulty in determining ownership or encumbrance

It is often difficult to determine the identity of the true owner(s) of an IP since not all forms of IP are subject of registration, for instance copyright of creative expression cannot be registered. The automatic protection is vested in authors but this also gives rise to the difficulty of ascertaining ownership. Even where such IP is registered, there is the risk of the validity of the IP being challenged for instance a trademark may be expunged from the register on the basis of non-distinctiveness and thus where the IP is found invalid, its unliquidated value simply vanishes.

There is limited time for exploitation, the statutory monopoly given by IP legislations over certain IPRs is limited and after said duration, the exclusive rights vested in the owner or proprietor expire and said works fall into public domain.

This uncertainty might lead to additional costs incurred on the part of the creditor who might have to conduct due diligence in ensuring that there aren't additional interests such as joint owners or licensees.

(b) Separability of the IP

There are situations where it is difficult to separate the IP from other components of the business, for instance a patent might be so interlinked with certain know-how or trade secret of the company, that when it becomes separated from these other components, it becomes useless to the creditor.⁵⁰ Also copyright could be complementary by a patent and won't be functional on its own.⁵¹

(c) Valuation

The principle of valuation is the worth of the asset to the buyer and seller so that if the price of an asset is greater than the value of the asset to the seller and less than the value of the asset to the buyer, it will be exchanged.⁵² The valuation of IP is important for so many reasons, it includes determining business value, allocation of capital, taxes, licensing rates and calculation of damages in infringement situations.⁵³ Thus valuation is so important, an IP asset will not be accepted as security if its value is unascertainable.

There are three methods of valuing IP and they are income method, market method and cost method.

⁵⁰ Locke op cit (n33) at 718.

⁵¹ Ibid.

⁵² I Davies 'Secured Financing of Intellectual Property Assets and the Reform of English Personal Property Security Law' (2006) 26(3) *Oxford Journal of Legal Studies* 559 at 576.

⁵³ Ibid.

Income method is based on the ability of the IP to generate future income, it values the IP asset on the basis of the amount of economic income that it is expected to generate, adjusted to its present day value.⁵⁴ The characteristic of this method is its ‘intrinsic value’ that is the ability of the IP asset to generate positive cash flow. It is the most commonly used form of valuation though it is only applicable to IP assets which have a long earning history.⁵⁵

Market method is based on a comparison of the actual price paid for the transfer of rights to a similar IP asset under comparable circumstances, it is often based on market information and it is also used to determine royalty rates, tax and income method.⁵⁶ This particular approach can be found lacking because it might be difficult to find comparable benchmark data since IP assets differ in respect of their scope and nature, and IP asset collateralisation is often kept private between parties.⁵⁷

The cost method is used to establish the value of the IP asset by calculating the cost of a similar IP asset, it is particularly useful when the economic benefits of the assets cannot be quantified. This method does not however take into consideration wasted costs nor does it consider any unique characteristics of the asset,⁵⁸ also investment on R&D is not enough to predict the future value of an IP asset.⁵⁹

The methods of calculating the value of an IP asset are not however immune to susceptibility to market changes or fluctuations in value. IPRs are known to vest statutory monopoly in the owner, the issue is what happens when such IP asset depreciates in value due to technological innovations by competitors which might reduce the demand for the holder’s IP asset.⁶⁰ The actual value of the IP asset is dependent on the holders’ ability to exercise their exclusive rights which is heavily contingent on the competitive position of the holder and the demand for the product protected by the IP.⁶¹

There are different accounting standards often used in evaluating the value of IP such as the International Financial Reporting Standards (IFRS), US Generally Accepted Accounting Principles (US-GAAP)

⁵⁴ WIPO ‘Valuing Intellectual Property Assets’ available at https://www.wipo.int/sme/en/value_ip_assets/ accessed on 8 October 2022.

⁵⁵ M Lin *Law and Economics of Security Interests in Intellectual Property* Unpublished PhD Thesis, (2017 Universities of Bologna, Hamburg and Rotterdam) at 71.

⁵⁶ WIPO op cit (n54).

⁵⁷ Lin op (n55) at 72.

⁵⁸ WIPO op cit (n54).

⁵⁹ Lin op cit (n55) at 71.

⁶⁰ Lin op cit (n55) at 65.

⁶¹ Lin op cit (n55) at 67.

and the EU Accounting Directive, these different standards often give rise to a divergence of perceptions of the value of IP between the lender and borrower which might result in over-collateralisation.⁶²

This paper overall suggests that proper and substantive examination of IP before registration which might make valuation easier for IP holders and prevent the constant divergence of perceptions of the value of IP between parties to a security agreement.

4. Conclusion

This paper has examined the uncertainty surrounding the classification of IP in South Africa which can be traced to the *Gallo Africa* case, it submits however that it is evident that the Copyright Act deems IP a movable property and the court in *Gallo Africa* appears to have ignored the Copyright Act and simply based its decision on the territorial nature of IP. This paper however suggests that an express classification of IP in each relevant IP legislation could go a long way towards resolving this impasse.

This paper also examines the various ways security could be created over the various forms of IP, it recommends express provisions for the hypothecation of copyright and plants breeders' rights and it is suggested that creation of new and well detailed registers might aid transparency of any encumbrance on the IP assets. Contractual restrictions which require the consent of the licensee before further encumbrance is created over the IP asset could go a long way in achieving transparency.

Valuation of IP is an age long issue with collateralisation of IP, this paper submits that while due diligence might be costly, it is inevitable for parties to get expert advice on collateralisation of IP. In spite of these challenges raised, IP still remains an efficient way of creating security for financing and organisations such as the World Intellectual Property Organisation (WIPO) have taken strides via publications and conferences for the purpose of resolving challenges surrounding the utility of IP.⁶³

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⁶² Lin op cit (n55) at 74.

⁶³ WIPO op cit (n54).

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