



Perfectly secure

As traditional methods of making money available to borrowers become less attractive, the sale and licence back of intellectual property could emerge as a favoured tool. But it will need a leap of faith from both parties in a transaction if this is to happen

Each one of us requires the spur of insecurity to force us to do our best
Harold W Dodds

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In a perfect world we would always be secure in our actions and their consequences. We would advance towards the future with certainty and confidence. The unknown would yield to our diligent research and reward us with the next useful knowledge to protect our competitive advantage. Failure would only be a measure of our inaction in the face of opportunity. Our pensions would never fail. But alas, we do not live in a perfect world.

Banks and financiers also want a perfected world. In this case, intellectual property may be the perfect asset for the moneyed professions. Banks lend money on behalf of their depositors, as do financiers on behalf of their backers. The objective is to get this money back with interest. Because the world is not perfect, banks look for ways to make lending more secure. Today's method of choice is a security interest in property of the borrower.

A security interest is a contract to give over property of the borrower to the lender in the event that the borrower stops paying on the loan. So long as the property is worth more than the loan balance, the lender is made more secure in its expectation of getting paid. This helps to keep interest rates low and lending robust. To bring these private dealings under the rule of law, the lender files its contract with the local jurisdiction to perfect a security interest.

This system of financing has been evolving for a few millennia and works extremely well for plant, equipment, inventory and real estate. If a borrower fails to pay, the lender can go back to the courts and get the necessary writs to repossess the secured

property. Until two decades ago, the typical large business could obtain secured borrowing for up to half its enterprise value because this was the value of the business assets on the books. However, for the last 20 years, enterprises have been winnowing down their capital spending and outsourcing – all of which means that today there is only US\$10 in business assets for every US\$100 of average enterprise value.

Lenders have, therefore, shifted towards unsecured lending, where the security of the loan relies on the borrower's promise to pay. This is how credit cards operate. So long as the borrower makes enough income to pay its obligations (and actually pays them), an unsecured debt is just as good as a secured one and perhaps better, as unsecured lending pays higher interest than the typical secured note. A rising economy, like the tide, raises all boats, so there is enough money to float a host of new and bigger loans. But what happens when the tide runs out?

The American consumer may be the poster child for the excesses of unsecured borrowing. While the United States is still the richest nation on earth, its citizens save less now than at any time since the Great Depression. One reason is credit cards and easy terms for this credit. American consumers, by living at or beyond their means, have catalysed an economic renaissance in China and other emerging economies through the ocean of exports that easy credit stimulates. But citizen debtors can settle debts another way – bankruptcy. Bankruptcy laws create a fresh start for the debtor by destroying debts. The shortfalls of lender repayments ultimately result in higher interest rates for everyone. Last month, to curb debtor abuses of the bankruptcy system, the US activated a new bankruptcy code. The immediate response was a threefold increase in the rate of weekly bankruptcies filings as compared to the situation under the old code.

This is where intellectual property has real import in the world of lending. IP is a critical asset and a significant portion of the recently missing business assets must be IP. Most financiers will agree that an enterprise's IP, as a whole, is a valuable asset. The difficulty is in the rules of lending.

Licensing is how IP value is recognised because the royalties that IP licences will generate are revenues that can reliably estimate economic value. To make IP bankable, it must be bought so that it can be licensed to its seller. The sale and licence back of IP is an emerging concept that requires a double leap of faith. First, it requires lenders to confirm their belief in the value of IP by buying it. Second, it requires business sellers to confirm their belief in licensing as the means of obtaining the economic value of IP. Because licensing is a US\$150billion-plus a year global activity the economic value of IP is obvious.

IP sale and licence back may, in fact, be the perfect security for lenders and perfect money instrument for borrowers. The purchase of IP transfers title, which means that lenders have fully perfected their security interest. For borrowers, a licence is a completely deductible business expense which lowers taxable income and increases cash flow. In the event of default, a lender's first remedy is injunction against a licensee borrower. This is a legal right that precedes even creditor rights. The force of an injunction is a powerful incentive for borrowers to pay, which means default rates will be much lower. Over time that means lower interest rates in IP-backed transactions.

Borrowers constantly renew their IP assets to maintain a competitive advantage, which defines the economic life of current IP. By constantly renewing IP, lenders will be assured a continuous marketplace of fundable assets.

Given the alternative shouldn't we make the leap of faith into IP banking? It's perfectly obvious.

Doug Elliott is founder of TEQ Development LLC which is a licensor of business methods for intellectual property. The views expressed herein are those of the author and do not necessarily reflect those of TEQ Development LLC or its affiliates
DougElliottTEQ@aol.com