"VIRTUAL SECURITY": ENFORCEMENT ISSUES IN KNOWLEDGE-BASED INDUSTRIES

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It has been said that the only things certain in life are death and taxes. To that list should be added "change". Dealing with change is of particular significance for lenders in an environment where well-established lending practices and procedures are applied to situations that were not within anyone's contemplation at the time such practices and procedures were developed. Nowhere is this more evident in the customer base of our lender clients than with knowledge-based industries ("KBI"). KBI encompasses a wide range of companies including those involved in the manufacture or distribution of technology, those dependent upon copyrights, patents and trademarks or those requiring the special knowledge or expertise of particular individuals. Commercial transactions now often involve assets that cannot be touched or felt, as was historically the case, but rather are "virtual" or intangible. The ability of a lender to recognize these important issues affecting its lending practices and security will separate those lenders prepared for the 21st century from those who are not.

Lending to a KBI company involves a thorough analysis of all aspects of the loan transaction including the traditional "three C's of Credit" (cash flow, character and collateral) and security registration issues which would exist in any typical lending situation. However, due to the nature of assets which are generally financed in a KBI company, special care has to be taken both in terms of evaluating the credit risk, taking appropriate security in those assets and, in particular, realizing on the security in the event of default. Due to the breadth of this topic and the six minute format of each presentation, it is not possible to discuss in detail the obtaining of security over KBI assets or the manner in which same should be valued for the purpose of assessing the credit risk. This seminar will focus only on the insolvency aspect of KBI companies, that is: "getting the money back", and the security issues which usually accompany that exercise.

As we all know, the relationship between a lender and its customer is not static, nor does the status on the date of the initial advance necessarily mirror the loan and security documents which exist at the time of enforcement. In addition, a preliminary step often taken by lenders when a loan account becomes less than satisfactory (in some cases in consideration for not issuing a demand for payment) is to structure a form of forbearance agreement. For that reason, in any discussion of *enforcement* in KBI companies, it is useful to briefly review the security and related documents which a prudent lender *ought to obtain*, even though those documents may not have formed part of the initial loan and security package. If such security was not obtained when the loan was advanced, the time to ensure that such review has been completed is upon the customer's first request for any type of accommodation. This could include an increase in its operating line, a restructuring of its payments, a forbearance on certain terms or the request for a new facility which will be cross-collateralized with its existing facilities. Some additional documents (such as third party acknowledgements or assignments) are nearly impossible to obtain at any time other than prior to the initial advance by the lender. However, depending upon the relationship between the lender, the customer and the parties with whom the customer has contracts, these documents may be capable of being obtained at a later date. In all cases, every effort should be made to "plug the holes" in the existing security documents. This should include:

(a) a review of all assets which could be subject to copyright, trademark, patent or similar rights. In the event these rights are owned by third parties (not the borrower) a further review should be conducted to determine whether such rights have been assigned to the borrower and further assigned by way of security to the lender, or what rights (if any) the lender has in respect of these assets in an enforcement scenario. If these rights are in fact owned by the borrower, a specific assignment of such rights in favour of the lender should be obtained, either as a schedule to the General Security Agreement or in a separate assignment document;

(b) a review of all material contracts to which the company is a party. This should include a detailed review of any licensing or distribution agreements including the ability to assign same (whether by way of security or otherwise) and the rights of the licensor / distributor upon the insolvency of the company;

(c) a review of key employee contracts and the safeguards which are in place in respect of proprietary information and "know-how", as discussed in greater detail below;

(d) a review of all source codes for software and the updates for same, including confirmation that the lender has access to all such information in the event of enforcement;

(e) a review of all receivables to determine, in addition to the usual factors, whether the ability to collect the receivables is based upon ongoing servicing by the company or subject to set-off arising from outstanding warranty claims; and

(f) a review of all other KBI assets with a view to assessing their "shelf life", location and registration particulars. In such a fluid environment, the value of assets of KBI companies can change rapidly depending upon many factors including the development and release of competing products in the marketplace. Such products also tend to have a high value in the beginning, with a very short shelf life. Lenders therefore want to be cognizant of where the company is at in the cycle of a particular product, and ensure that there is sufficient "life" remaining in its products to repay the indebtedness owing to the lender.

In any insolvency scenario an analysis is generally conducted to determine the value of assets both in a liquidation scenario and on a going concern basis. The lender will then make a determination as to how it wishes to proceed, based upon the ongoing costs, risks and expenses of operating the business (and its resulting value) while attempting to locate a purchaser over a period of time. Compared to other industries, a significantly greater value differential will exist between a liquidation scenario and a going concern sale of a business for a KBI company. In many cases the company's only value depends upon its ability to continue to generate ongoing revenue through sales, relying upon its market recognition and goodwill. In such cases a lender who has failed to protect itself in the event of its customer's insolvency has little choice in respect of enforcement, other than to immediately suffer a significant loss or locate a purchaser for the business over a period of time. That being said, any seasoned lender knows that in some cases the "first loss is the best loss" and the costs and risks associated with attempting to sell a business as a going concern may far exceed its realization value.

The first step a prudent solicitor should take when retained on a file involving a KBI company is an assessment of the exact nature of the assets secured by the lender's security. This may appear too obvious a statement to even mention. However, traditional methods of reviewing security may leave a lender with perfectly valid security over all "property, assets and undertaking" of its customer which, in an enforcement scenario involving KBI assets, might prove quite meaningless.

Take for example a situation where you are retained by a lender who advanced loans to a KBI company involved in the distribution of CD Roms, computer software and related computer programs and games. Upon the occurrence of certain defaults the lender forwards its security to you for review, prior to taking any enforcement steps. You review the security which consists of your client's standard form General Security Agreement which appears to be properly executed and is accompanied by an authorizing resolution. You then review a certified PPSA search which indicates that your client has first registered priority over collateral described as "equipment, "inventory", "accounts" and "motor vehicles". The collateral classification of "other" is not included in your client's PPSA registration, and your client's documents do not include any registered assignments with the Canadian Intellectual Property or Trademark Offices.

In this example let's assume that the company's "inventory" includes an anti-virus software program called "Quick-Fix", originally developed by the principal of the company. The sale of this program has historically accounted for 35% of the company's annual revenue. Your client has always taken comfort in the fact that the "Quick-Fix" program is protected by a registered trademark, tradename and patent thereby preventing the company's competitors from distributing it in the marketplace.

If the only security held by your client is a General Security Agreement, it may find itself with very few options in the enforcement of its security. Most standard form General Security Agreements used by banks and similar lenders include "intangibles" in the description of collateral, and intangibles are indeed covered by the PPSA. However, due to the nature of intangibles, they usually comprise a "bundle of rights" which are susceptible to multiple ownership interests. For example, a software program developed by a company may involve:

(a) copyright ownership which has been sold to a third party in order to finance the development of the program;

(b) licensing rights which have been granted to another party through a licensing agreement (in some cases in exchange for payment of "up-front fees", therefore significantly reducing the realization value of the distribution rights in any enforcement scenario);

(c) merchandising rights (relating to the creation of an identifiable "character" in the program) which have been conveyed to a marketing company in exchange for an advance and a share of future merchandising sales; and

(d) a recognized tradename that carries significant goodwill in the market, which has been licensed to a third party.

If the company only holds one or two of the underlying rights and has sold or assigned the balance, it can be very difficult for a lender to realize the maximum value for the assets in an enforcement situation. A security interest in an intangible can only attach to the debtor's interest in that intangible. If other parties have rights in the same intangible the lender may be left with only limited rights in respect of same. Further, in the example given above, the collateral classification "other" was not marked on the lender's PPSA registration. A security interest in an intangible is arguably not "inventory" "accounts" "equipment" or "motor vehicles" and accordingly the absence of the collateral classification "other" may result in the lender being unperfected with respect to intangibles.

In the example given, provided the company is permitted to continue to distribute the software in question, it will continue to generate receivables which can be used to reduce its indebtedness. If, however, the company is not permitted to continue to operate the business the facts change dramatically. Assume that the company is in the business of distributing software and related products owned by third parties, most of which will be protected by copyright and trademark registrations in favour of such third parties. For example, computer programs developed by Microsoft cannot be manufactured by anyone other than Microsoft and cannot be distributed by anyone other than a distributor licensed by Microsoft. Furthermore, the computer games and software may be manufactured or licensed by (for example) Disney which means that Disney owns all of the cartoon characters and the unauthorized distribution of software or computer games bearing its trademarks will constitute an infringement of its trademark and copyright rights. Finally, the "Quick-Fix" anti-virus program which was developed by the principal of the company may be registered with the federal patent and trade-mark office in Ottawa, but such registration is likely to be in favour of the principal of the company who developed the program, not the company itself. Accordingly it is owned by the principal and not by the company. So long as the principal of the company remains in control of the company's operations he or she will presumably allow the company to continue to distribute the software program in the ordinary course whether on an informal basis or pursuant to a distribution agreement between the company and the principal. In each of the above examples, at least one significant component in the KBI "bundle of rights" is therefore not owned by the company at all.

Licensing and distribution agreements for KBI assets owned by third parties almost always contain a clause which provides that the rights contained therein are personal to the company, cannot be assigned by the company and terminate upon the bankruptcy, insolvency or appointment of a receiver over the company. They usually also provide that upon such event occurring, the licensor is entitled to collect all of the unsold assets which are subject to its agreement and to prevent a third party such as a receiver from selling the assets. Some agreements also extend to the receivables generated from the sale of their product. In such a case it is imperative that a lender review the terms of each contract very carefully prior to advancing a loan, and determine what rights the company has upon insolvency or upon the appointment of a receiver. If the agreement contains an express prohibition against assignment, the lender should require an express acknowledgement from the manufacturer or licensor that the company's rights thereunder have been assigned to the lender and that it will not interfere with the lender's rights under such assignment in the event of enforcement by the lender. As it is practically impossible to obtain such an acknowledgement at any time other than prior to (and as a condition of) advancing a loan to the company, lenders should make this a usual part of their security packages.

Looking back at your initial review of the security (and the comfort you gained from determining that the lender had first registered priority under the PPSA) reflect once again on the nature of the assets over which your client has security. In a "worst-case scenario" (liquidation) what assets are available to be realized upon by the lender? The "Quick-Fix" anti-virus program is subject to ownership rights of the principal of the company which prevents any unauthorized sale or distribution by the lender without the owner's consent. In the absence of a specific assignment agreement or acknowledgement by the principal in favour of the lender, the lender is unable to continue to sell the "Quick-Fix" program comprising a significant part of the company's inventory. The balance of the company's inventory consists of software programs and computer games, all of which are probably subject to licensing, copyright and trade-mark rights of third parties such as Microsoft and Disney. In the absence of an assignment of such rights in favour of the lender or a third party acknowledgement in favour of the lender, it will be difficult to assert any rights over these assets in a realization scenario.

The "hard assets" (plastic cases and CD Rom disks) may be owned by the company, with a value of approximately $0.50 each. The real value of the assets is the information contained on the disks and imprinted on the packaging, which in our example is not owned by the company and accordingly cannot be sold by the lender and applied to reduce the company's indebtedness. The assets having the real value are therefore subject to the terms of licensing and distribution agreements between those third parties and the company. When all assets which are subject to third party rights are removed from the equation, the company may in fact only have a few chairs, a desk and a telephone available to be sold by an auctioneer.

If at the time the loan was granted to the company care was not taken by the lender or its counsel to review the terms of all third party contracts and a specific assignment of same obtained, the lender may be faced with an enforcement situation where it has very few choices.

As discussed above, another fact that should be reviewed very carefully prior to taking any steps to enforce security is the "know-how" or proprietary information which is essential to the company's operations. In a KBI company this is often controlled by one individual or a small group of employees. There is no formal registration system for recording a person's "know-how" or special expertise. However, trade secrets and "know-how" are protected by common law rules governing the protection of confidential information. If a sale of the business as a going concern requires the continued support of a key person with special expertise, the availability of this option will depend upon whether that key person is prepared to assist in such efforts by the lender. Employee non-competition and confidentiality agreements should always be obtained by a KBI company and strictly enforced, in view of the nature of the industry. In addition, the lender should ensure that at all times it has access to any proprietary information including all source codes for software programs owned by the company or for which the company has access. The updating of information as to all source codes should be an ongoing covenant requirement, to ensure that at the time of enforcement the lender has all updated or amended source codes for complete access to the software.

The focus of this presentation and the examples provided in this paper relate to what could be considered "high tech" companies, which is really the core of knowledge-based industries. However, the issues relating to the enforcement of security and the problems which can arise if appropriate steps are not taken, are not limited to those specific types of companies. In particular, lenders are often faced with situations where they are financing the manufacture and sale of clothing which may be subject to trade names, brand names or logos registered in favour of third parties. In such cases the lender may have security over the "hard assets" being the cotton or nylon used to make the clothing. However, those items may have embroidered team names or athletic logos stitched onto them, which are practically impossible to remove without destroying the underlying product. In order to avoid having only one purchaser for this inventory in the event of realization, lenders usually obtain acknowledgements or agreements from those third parties whose logo or name will be affixed to the goods, to permit the lender a reasonable period of time to dispose of the collateral in an enforcement scenario.

In a rapidly-changing environment it is not sufficient to simply be satisfied with the "status quo" in the advice given to lenders and precautions to be taken in the enforcement of security. Lawyers involved in the enforcement of security in the 21st century need to be familiar with all issues which could result in their clients' security being unenforceable on a practical level. A failure to do so may very well render their client's rights and remedies equivalent to "virtual security".