

# Innovation financing security | Vancouver Business Journal

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## An illustration of financing failure

As we charge into the 21st Century, technology becomes ever more the majority asset in small-to-midsize companies. Numerous software and computer companies, as well as optics and other technology-based businesses increasingly call Clark County and Vancouver their home. Financial firms stand to raise their bottom line through savvy technology enterprise funding, or lose their shirt. Sadly, most financial institutions have yet to learn how to properly secure financing in innovation, resulting in either failure to provide innovation financing at all, or, having provided the funding, failing to secure the financing in the event of catastrophe.

A hypothetical example, that is probably all too familiar to some, illustrates the issue:

Sam Startup creates a smartphone and tablet application that is used to control household appliances. Sam secures \$100,000 in financing from Ben Banker to take his company to the next level after going through numerous financiers. Ben, a savvy risk taker, takes a blanket security interest that includes inventory, receivables, as well as (importantly) intellectual property such as patents, trademarks and copyrights. Ben makes a UCC filing with the state to perfect that security interest.

A year later, Ann Angel provides a second round of financing of another \$100,000 to Sam with a security interest taken in Sam's intellectual property such as patents, trademarks and copyright. However, she records her security interest with the U.S. Patent & Trademark Office. Sam, who lived high on the hog and bought a McMansion that is now underwater, defaults and goes into bankruptcy. His inventory is insignificant, and his receivables uncollectable. He does have a catchy trademark, which he registered federally, and a patent application pending. He also filed a copyright registration application on the software that ran his invention.

Ben and Ann each file with the bankruptcy court to foreclose their security interests on the intellectual property. Ben says he has priority as a secured creditor over Ann because he filed proper UCC-1s with the State that reasonably described the collateral. Ann says she has priority as a secured creditor over Ben because she properly recorded with the Patent & Trademark Office. The trustee responds that none of the security interests are perfected and therefore the creditors should be treated as unsecured because they should have both filed a UCC-1 with the state and recorded at the Patent & Trademark Office. The bankruptcy judge gets interested and reads deeply into what is the generally prevailing law. Based on the current state of the law, the judge correctly rules that Ben is a properly perfected creditor as to the patent application and the trademark. Ann is an unsecured creditor, which means she gets nothing. The court further rules that nobody has a perfected security interest in the copyright registration because that should have been filed with the Copyright Office of the Library of Congress, and so the copyright registration remains the property of the estate.

Ann walks away unhappy and dispirited at her adventure in venture capital financing. Ben, however, shortly finds that he too is in a bad position. He can't sell the patent application and trademark registration to Elephant Enterprises because Elephant's attorney informs them that the product can't run without the software. If Elephant

runs the product with the software, it will risk copyright infringement liability from the estate. The trustee sees the leverage it has and demands significant value from Ben in order to agree to sell Ben the copyright registration as well. Ben ends up taking a significant loss and fires his outside attorney for not perfecting his security interests correctly.

The trustee ends up making money for the estate through his leverage with the copyright application. After taking his healthy cut, the manna is divided up between all the unsecured creditors, which include Ann, and they all get five cents on the dollar for their claims.

Ben's new counsel tells him the following:

- Always file both UCC-1s with the state and record with the Patent & Trademark Office for any security interests that include patents or trademarks.
- Always record with the Copyright Office of the Library of Congress for any security interests that include copyrights.

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