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FINANCING AND INTELLECTUAL PROPERTY — MAXIMIZING FINANCING OPTIONS THROUGH INTELLECTUAL PROPERTY ASSETS

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In recent years, lenders have demonstrated an increasing interest in intellectual property assets, which may be described as "intangible" assets. This is excellent news for businesses in the knowledge and technologies sector whose main assets are often their intellectual property rights. The ability to take advantage of this type of asset may allow medium and small businesses, as well as larger businesses, to increase their capacity to obtain financing and also improve financing conditions.

Indeed, the *Civil Code of Québec*[1] enables businesses and natural persons carrying on a business to grant security both on corporeal property and incorporeal property, which includes intellectual property rights.

What do these intangible assets consist of? Intellectual property rights include patents, copyrights, industrial designs, plant breeders' rights, integrated circuit topographies and trade-marks.

Historically, businesses in the knowledge and technologies sector have mainly been financed by venture capital funds offering credit conditions that were often more onerous than those offered by traditional lenders. A greater number of traditional lenders are now open to the idea of financing this type of business. This new approach may be advantageous to such businesses, since it offers them a wider range of financing sources.

Such a financing opportunity is particularly interesting in the current period of tightening credit conditions resulting from the increased prudence of financial institutions due to the crisis which has shaken world markets. In such a context, businesses will be interested in maximizing their total value and improving their credit conditions. One of the real impacts of this crisis is that it has reversed the balance of power between lenders and borrowers, which heavily favoured borrowers in recent years, given the ready availability of credit. As we are now witnessing a swing of the pendulum in favour of lenders, the negotiation of credit conditions has become more difficult for borrowers. Among the noticeable impacts of this change, we note that certain lenders will seek to re-evaluate existing credits, and they may also require that new security be granted to secure such credits. The assessment of the real value of the intellectual property rights that are available as security to a lender may not only enable businesses to meet the more onerous requirements of their lenders for existing financings, but, for businesses seeking new financings, may also allow for an increase in the amount of new credit granted, and favourably affect the rates charged for such credit.

However, lenders face some degree of uncertainty in granting security on intellectual property rights due to the difficulty of valuing these assets. The value assigned to such assets depends on many factors, such as the territory in which the rights are granted, their notoriety and scope, the certainty of the business's ownership of such rights, whether or not security has already been extended thereon to other creditors, the distinctiveness of the asset in the case of a trademark, and the potential income or royalties that such assets can generate, particularly through licensing (subject, however, to the terms and conditions of the licence agreements). Although the value of an intellectual property right can be difficult to establish with accuracy, there are firms that specialize in this area. An astute entrepreneur will be interested in knowing the potential of this type of asset.

1. Articles 2666 and 2684 of the *Civil Code of Québec*.

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The view of traditional lenders toward businesses in the knowledge and technologies sector has evolved over the last few years. They are now more prepared to finance this type of business where there is an existing valuation of the intellectual property assets, or one is planned. In this context, businesses in the technologies sector must determine whether the cost of such a valuation of their intellectual property assets, possibly enabling them to obtain additional financing, is warranted.

THE MATERIAL ADVERSE CHANGE CLAUSE: A STRONG TOOL

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The recent financial crisis has shaken the global economy and forced some of the largest economies in the world to restructure their financial systems. Since this crisis is related to the scarcity of credit, it has had a significant impact on almost all the sectors of the economy, and the sector of mergers and acquisitions has not been spared. The amount of available credit having significantly decreased, businesses no longer have at their disposal the financial resources required to make acquisitions which would give them strategic advantages over their competitors. As a result, one of the recent effects of the lack of credit availability is an increasing number of acquirers who withdraw from a business acquisition, even after the merger and acquisition contract is signed, on account of the financial and operational prospects of the target business not being as good as anticipated or the purchaser finding that obtaining the required financing is more difficult than originally foreseen.

A specific provision found in merger and acquisition contracts is mostly responsible for this new trend. This contractual provision which allows the purchaser to terminate the transaction even after the execution of a merger and acquisition contract is named "material adverse change clause" or "material adverse effect clause". The main purpose of this clause is to protect the potential business purchaser against any deterioration of the operational or financial situation of the target business between a date agreed upon by the parties and the acquisition closing date.

What is a material adverse change ("MAC")? In general, a MAC is any change, effect, event, occurrence, condition or development which has or may reasonably be expected to have, on an individual basis or globally, a material impact on the target business, its future prospects, operation, operating results, assets, capitalization or financial condition and those of any related company.

By invoking this clause, the purchaser mainly seeks to terminate the transaction without being required to pay an indemnity because of such termination. The purchaser may also use this clause as leverage to renegotiate the merger and acquisition agreement on more favourable terms.

When negotiating the merger and acquisition contract, the purchaser would be well advised to ensure that the content of the MAC clause is as broad as possible, thus increasing the scope of situations which would allow the purchaser to terminate the merger and acquisition contract.

The seller, on the other hand, should try to limit the scope of the MAC clause. For instance, the seller must insist on the importance of not using the future prospects of the target business as a MAC as this promotes a very broad interpretation of the clause. It is also important for the seller to insist that the MAC clause take into consideration the general situation of the target business and its subsidiaries as opposed to only the situation of a particular department or subsidiary. This will avoid allowing the potential acquirer to rely on the precarious situation of a particular department or subsidiary of the target business as a justification to invoke the MAC clause.

Lastly, the seller must ensure that exceptions are included to restrict the scope of application of the MAC clause with the objective of excluding certain events, so that their occurrence does not constitute a material adverse change. This type of exception includes, for instance, the occurrence of a terrorist attack, a change in interest rates or a change in the legislative environment of either the seller or the purchaser. It is important for the seller to ensure that the list of exceptions is not exhaustive and to specify that these exceptions only serve to facilitate the interpretation of the MAC clause. If this is not stipulated, there is a risk that an event not mentioned in the list of exceptions, which is however similar to another event in the list, may be deemed to constitute a material adverse change.

Considering the current economic situation, the MAC clause has become a strong contractual tool for the purchaser, either to terminate the merger and acquisition agreement or to renegotiate the terms of this agreement to his advantage. Do not hesitate to discuss with your legal counsel when preparing documents that may include this type of provision.

LAWSUITS AGAINST CORPORATE DIRECTORS: IT DOESN'T JUST HAPPEN TO OTHERS!

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Lawsuits against directors are not restricted to public corporations. Directors of small and medium-size corporations may also face judicial proceedings.

Individuals who are called upon to become members of the board of director of a corporation, irrespective of its size, should ensure that effective and durable mechanisms are implemented for indemnifying them in case they become the subject of proceedings related to their duties as directors.

At the time judicial proceedings are instituted, the individuals concerned often have ceased to be directors. Consequently, this protection should not only be in effect for the duration of the directorship but also thereafter.

The *Canada Business Corporations Act*[1] and the *Companies Act* (Quebec)[2] provide that in certain circumstance and under certain conditions, a corporation may have to indemnify a current or former director for actions taken in the course of his or her duties. The legal provisions in the incorporating statutes are subject to interpretation and can sometimes be ambiguous. The protection under these legislative provisions is not complete.

It is possible to include the obligation to indemnify in a corporation's by-laws or a resolution of its board of directors. However, the corporation may unilaterally amend such provisions without the former directors' intervention being required. Accordingly, former directors cannot invoke rescinded or amended provisions of a corporation's by-laws or resolutions which provide for the terms of indemnification.

In order to reduce the uncertainties, a corporation's directors may enter into an indemnification agreement with the corporation, which will set out the corporation's indemnification obligations to the directors. This type of agreement may contain provisions dealing with the following items:

- the choice of legal counsels and the payment of their fees;
- the terms governing monetary advances;
- the corporation contracting a liability insurance policy for the director.

Such an agreement may not be amended without the consent of the director who is a party thereto.

An indemnification agreement should also clearly define the nature of the judicial orders covered under the agreement and provide for terms of payment, including the advances that may be made. It is possible to specify, for instance, whether administrative or tax courts are covered. It is also advisable to provide for the terms regarding the indemnification and the advances that the corporation may or may not pay in case it institutes proceedings against one of its own current or former directors.

It is important to note that the liability insurances currently available on the market are not equal and that the scope of coverage may vary considerably from one policy to the other.

However, entering into an indemnification agreement should not constitute a universal remedy for a corporate director since the payment of the advances and, ultimately, the indemnification under the agreement may be jeopardized if the financial condition of the corporation precludes it from making such payment.

1. Section 124
2. Sections 123.87, 123.88 and 123.89

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