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Financing Alternatives for Companies: Using Intellectual Property as Collateral

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For many intellectual property ("IP") centric companies suffering from Cash Flow constraints, traditional financing options may be unavailable or too expensive to pursue. Using IP as collateral is an emerging business option that may offer a financing opportunity for companies with valuable IP assets seeking alternative sources of capital. In this article, we will examine some of the ways businesses can capitalize on their IP by using it as collateral for funding.

Companies large and small may need additional capital for a variety of purposes. Startup and smaller companies may need capital for such reasons as starting up or expanding operations, sustaining or increasing their research and development spending, or for complementary acquisitions. In addition, startups often need short- or mid-term loans to supplement various rounds of funding. For established companies, financing requirements may stem from marketplace challenges, the need to expand, or a myriad other reasons. For instance, following the 2009 recession, companies experienced difficulty in securing capital as banks restricted the number and amount of loans to businesses. Fortunately, for some businesses, a realistic alternative to traditional financing is collateralization of their IP assets.

In this article, we will discuss the use of IP as collateral for certain financing arrangements. In the context of IP, collateral can be defined as a borrower's pledge of specific property, such as future Cash Flows from existing IP assets, or rights to the underlying IP itself, in order to provide recourse for the lender in the event of loan default. Historically, the practice of obtaining financing secured by one form or another of IP, while relatively rare, was not unheard of. One well-known instance of using IP as collateral occurred when Thomas Edison used his patent on the incandescent electric light bulb as collateral to secure financing to start his company, the General Electric Company.[1]

In recent years, however, it has become increasingly common for lenders to file liens against IP assets. According to a paper by William Mann at Wharton, "[o]f the stock of United States patents, 16% have been pledged as collateral at some point."[2]

Arrangements Using IP as Collateral

The market for IP-collateralized debt is primarily served by specialty lenders. However, a number of traditional banks and finance companies are warming up to this financing strategy.

Specialty lenders offer a wide range of financing vehicles for borrowers who wish to use their IP to secure funding. Ranging from traditional loans to mezzanine debt with equity conversion clauses, lenders and investors can now structure many creative forms of financing based on a borrower's specific capital needs. For this article, we focus on the more common uses of IP as collateral: IP-backed loans, IP collateral enhancement, IP royalty securitization, and IP sale and license-back transactions.

[1] Brian W. Jacobs, "Using Intellectual Property to Secure Financing after the Worst Financial Crisis Since the Great Depression," 15 Intellectual Property L. Rev. 449 (2011). http://scholarship.law.marquette.edu/iplr/vol15/iss2/6.
[2] Mann, William, "Creditor Rights and Innovation: Evidence from Patent Collateral", Wharton, May 1, 2014. Available at: http://fnce.wharton.upenn.edu/pro_le/1033/.

IP-Backed Loans

For conventional asset-backed loans, lenders typically turn to physical assets, such as inventory, machinery, or real estate, in determining loan size and terms. The borrower grants a security interest in these assets to the lender as collateral against the loan. IP-backed loans are similar to their tangible asset-backed counterparts. Under these arrangements, a company can borrow a percentage of the value of certain of their IP assets using these intangible assets as collateral. For both tangible and intangible assets, asset-based lenders assess credit risk, at least partially, on the basis of the value and liquidity of the underlying collateral.

Unlike tangible assets, where depreciated historical value can typically be determined from a company's balance sheet, internally developed IP is not typically recognized on a company's balance sheet. Rather, expenditures associated with internally generated intangibles are normally expensed in the period incurred through the income statement. On the other hand, purchased intangible assets are typically capitalized and normally appear on the company's balance sheet,[3] either directly if only the IP was purchased, or as part of the acquirer's requirement to allocate the purchase price amongst the acquired assets in a business acquisition.

Between the lack of transparency under Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) and the need to identify liquidation value (as opposed to "going concern" value), an independent valuation of the IP is almost always necessary in order to establish the value of these assets for lending purposes. David Peress, Executive Vice President of Hilco Streambank, a firm specializing in executing complex IP sales and licensing transactions, believes that valuations are a critical step in the process of lending against IP as they are used to help determine how much a lender can lend against this asset class. For patents and trade secrets, the valuation of these assets requires a deep understanding of the legal, technical, and economic issues surrounding the inventions. Similarly, a substantial amount of expertise is required to value marketing assets such as trademarks and trade names. For a given loan amount, lower asset values result in a higher loan-to-value ratio, which means higher risk for the lender.

This type of secured lending is often a desirable form of borrowing for companies that have valuable IP, but a lack of unencumbered tangible assets, a sufficient credit rating, or an adequate track record of generating excess Cash Flows to qualify for more traditional types of financing, debt capital markets, or unsecured bank borrowing. Additionally, such loans allow the company to generate cash without diluting current equity investors' ownership by bringing in new investors. On the other hand, such loans are often relatively costly; the loan-to-value ratio is normally lower than it would be with more liquid, less risky collateral. Also, using IP as collateral may diminish future managerial freedom due to debt covenants and other obligations to lenders.

IP-backed lending is not an option unique to early-stage technology companies. Kodak's patent portfolio was used as collateral to secure a $965 million line of credit that helped keep its doors open during its bankruptcy proceedings.[4]

IP Collateral Enhancement

IP collateral enhancements (e.g., insurance or guarantees on the value of the IP for a defined duration) reduce credit and foreclosure risk, thereby improving the overall credit profile, increasing leverage available to the borrower, and possibly lowering interest rates demanded by the lender. By guaranteeing the value of IP, firms offering IP collateral enhancements make it easier for companies to use IP as collateral for loans.

For some creditors, IP is likely to be an enhancement to a collateral package, rather than the basis of a stand-alone deal. Collateral enhancement firms that specialize in IP transactions, such as M•CAM Global Holdings LLC ("M•CAM"), assist regulated banks and traditional asset-based lenders who may not have all the tools, skills, and experience necessary to confidently evaluate IP as collateral. IP collateral enhancement provides the lender (and its regulators, as applicable) with a creditworthy ('A' rated or better) "floor" value upon which to determine lendable IP collateral advance rates. M•CAM has expertise in underwriting intangible assets in order to provide collateral enhancements. Adam Tepper, Chief Strategy Officer, explains M•CAM's Certified Asset Purchase Price ("CAPP") program as follows:

> A borrower applies for a loan with a lender where the borrower's intangible assets are pledged as collateral. Concurrently, the lender purchases a CAPP insurance policy from a consortium of creditworthy insurers participating in M•CAM's CAPP program whereby, in the event of the borrower's loan going into foreclosure, the CAPP policy provides the lender with an insured value for the borrower's intangible asset collateral upon transfer of the title from the lender to the CAPP insurers. At loan origination, M•CAM's insured value for the collateral is predetermined based on a pre-agreed to schedule over the loan period.
>
> However, the lender is not obligated to sell the insured intangible assets to M•CAM. The insured value, in many cases, acts as a "floor" value or "stalking horse" bid as part of the bankruptcy liquidation process. Accordingly, the lender will always be guaranteed to get no less than the insured value while maintaining any upside should the assets be worth more than the insured value.

[3] The primary reason for this difference in generally accepted accounting principles ("GAAP") treatment is that the arms-length value of purchased IP is evident from the purchase transaction itself while the future benefits from internally generated IP are typically much less certain and are often difficult to quantify.

[4] Kodak gets Bankruptcy court OK for patent sale" Financial Review January 15, 2013. http://www.afr.com/p/technology/kodak_gets_bankruptcy_court_ok_for_v4sPVrsgNQKFWMMq9Mm0tN.

M•CAM's proprietary analytic system determines the value for IP assets by assessing three main considerations:

- How long will the company and the targeted marketplace be depending on the innovations protected by the IP assets? As innovations can be rendered obsolete by newer technologies, it is important to determine whether the innovations are early or late in the technology lifecycle.
- How active is the market for intangibles similar to those serving as collateral? What form does the activity take (e.g., licensing, cross-licensing, purchases and sales of similar IP)? Do these transactions represent cash expenditures or in-kind purchases?
- Do secondary markets for the innovations serving as collateral exist and what are the sizes of those markets? That is, are there other applications of the innovations outside of its original intended field of use? For example, can the owner transfer the IP for a laser missile guidance system to the manufacturer of a high precision surgical device?

An example of such an IP credit enhancement, provided by another credit enhancement firm, was a transaction involving a 2004 loan to BCBG Max Azria Group, a manufacturer and retailer of women's apparel. Of the $53 million dollar loan transaction, $12 million was supported by a guarantee issued by the third-party credit enhancement firm based on collateral comprised of the company's portfolio of trademarks.[5]

When assessing collateral for collateral enhancement purposes, a key question for lenders and bank regulators is whether the collateral can be sold or monetized in a reasonable period of time, says James Loder, former Chief Underwriter with XL Insurance. According to Mr. Loder, with the exception of well-known brands, trademarks may be less desirable for use as collateral because of the perceived difficulty in monetization of those assets. He explains that if a brand is tainted, but the technology is still viable, the technology can still be used independently of the brand associated with it.

The typical term of IP collateral enhancement coverage underwritten by M•CAM is no more than five years, and the fees vary based on the perceived riskiness of the borrower and the IP assets. An underwriting fee of 0.25% to 0.50% of the face value of the policy is collected from the lender (and usually charged back to the borrower) at the closing of the loan. In addition, an annual premium ranging from 2.0% to 4.0% of the policy value is charged to the lender (and usually passed on to the borrower) for the duration of the arrangement. According to Mr. Loder, approximately a dozen transactions have been consummated to date in the marketplace; he also notes that IP collateral enhancement is a relatively new product. As more lenders become comfortable using IP as collateral without any guarantee or insurance, there may be downward pricing pressure for collateral enhancement services.

IP Royalty Securitization

There are many forms and legal structures used to facilitate IP royalty securitization. However, IP royalty securitization itself is a relatively straightforward process that involves the IP owner pooling and selling future IP-related income streams in exchange for a current lump-sum payment. In a typical securitization, in exchange for a lump-sum payment and a royalty-free license, the IP holder would transfer the IP assets to a special purpose vehicle ("SPV"). All future earnings generated by the IP assets flow to the SPV, which are then distributed to investors. Under this deal structure, the original IP asset holder no longer is the legal owner of the IP assets; hence, the assets are shielded from creditors in the case of the original IP owner's bankruptcy.

The difference between this financing method compared to an IP-backed loan described previously is that the IP owner securitizing its assets is not borrowing money, but rather is selling a stream of anticipated future Cash Flows that would otherwise accrue to the owner of the IP assets. Furthermore, unlike IP-backed loans or traditional bonds, with securitization, the burden of repayment is shifted away from the originator to the designated pool of assets. The originator is therefore protected from the operating performance of the securitized assets.

A high-profile example of an IP securitization occurred in 2007 when Sears created $1.8 billion worth of bonds based on the brand names Kenmore, Craftsman, and DieHard. Sears transferred ownership of the brands to a separate, wholly owned, bankruptcy-remote SPV named KCD IP (for Kenmore Craftsman DieHard IP). KCD charges Sears royalty fees to license those brands and uses the royalties to pay the principal and interest on the bonds.[6]

IP Sale and License-Back Arrangements

IP sale and license-back financing is worth considering for companies looking to raise capital. Sale license-back financing is similar to the sale lease-back model of real estate and occurs when the IP assets are purchased and assigned to a licensing company (the back-licensor). Concurrently, the back-licensor contracts a license to the same asset to its former owner (now the back-licensee) for stipulated royalty payments during a specified period of time. The arrangement can have a purchase option whereby the back-licensee can exercise the option to buy back the ownership of the asset at a fixed price at the end or during the back-license contract period. The company receives immediate funding to

[5] "Fashion Designer BCBG Max Azria Picks Up $53 Million; Bond Collateralizes Intellectual Property and Trademarks", PRWeb, December 13, 2004 (http://www.prweb.com/releases/2004/12/prweb188407.htm).
[6] "The New Alchemy at Sears", Bloomberg Businessweek Magazine, April 15, 2007 (http://www.businessweek.com/stories/2007-04-15/the-new-alchemy-at-sears).

reinvest in the business, and the back-licensor company can structure the contract to pursue additional monetization of the asset. This financing mechanism allows the IP asset owner to secure funding through the sale of its IP portfolio, without inhibiting the utilization of the asset in its business operations.

According to Doug Elliott, founding partner of Carthage Intellectual Capital Management ("Carthage"), IP sale and license-back financing is "ideally suited for mezzanine-stage, private equity and venture-backed companies requiring additional, non-dilutive capital for expansion, management buy-out, or acquisition of technology from a third party. These companies often have net operating losses to shelter any gains from the IP sale, and payments are fully tax expensed as a license." An IP sale and license-back arrangement may be a taxable event in which case any gains the company makes on the sale of the IP can be offset by any net operating losses it may be carrying.

Carthage looks for companies with IP assets that are central to its business operations. The cost of the financing or the license payments is determined by a variety of factors, including the financial position of the company and strength and duration of the patent portfolio. Closing costs can range from 4% to 8% of the purchase amount. The responsibility of paying maintenance and other patent costs can be the obligation of the back-licensor or the back-licensee depending on how the arrangement is structured. The royalties charged in the license would generally be lower than the royalties charged otherwise if the back-licensee covers these costs, says Mr. Elliott. Carthage uses proprietary and patented systems to value, monetize, and manage other IP assets where a sale and license-back is an attractive financing strategy for IP owners.

An example of an IP sale and license-back transaction occurred in 2004 between Motorola and GE Commercial Finance ("GE"). In that deal, Motorola sold a portfolio of non-core patents to GE for an up-front fee of $50 million, and an undisclosed percentage of royalties collected by GE over the years following the sale. M•CAM was the structuring agent on the transaction.

Advantages and Disadvantages of IP as Collateral

Given the growing recognition of IP as an asset to be collateralized, there are a number of advantages and disadvantages to consider when looking into the financing options mentioned earlier, including:

Advantages of using IP as collateral

- IP offers different avenues for monetization to the asset owner by increasing the pool of available credit to a borrower. Corporations are able to receive additional leverage and/or a lower cost of funding if a company is able to secure credit from lenders for its intangible assets as compared to relying solely on tangible assets for financing.
- IP can increase the owner's return through leveraging. Monies secured through financing are collected in one lump sum rather than over time and the lump sum can then be invested in projects that are expected to have a higher return than the cost of financing. IP provides a conduit to financing that 1) may not otherwise be available 2) doesn't cause the dilution of the existing equity positions and 3) may be less expensive than certain other alternative financing options.
- It may be more attractive to finance the IP assets on a basis that is predicated on the strength and performance of the IP assets rather than the creditworthiness of the borrower. If the IP assets are a consistently revenue-generating part of the company, they may have a more attractive Cash Flows stream for lending than the company as a whole, which may lead to lower execution costs.
- IP-based financing may offer some options for businesses to hedge themselves from risks. With securitization, for instance, the obligation of the IP's performance is shifted away from the originator and the assets are safeguarded from bankruptcy proceedings.

Disadvantages of using IP as collateral

- If the IP is the company's primary asset and pledged as collateral, a default on the loan could result in the loss of the IP and a termination of the company.
- More established forms of collateral, such as tangible property, are generally more stable and often provide lenders with readily-available market information when assessing the value of the property. Because the valuation of IP is generally more difficult than for tangible assets, potential creditors are less willing to invest because they know less of how the market will react to the property in the future.
- Tangible assets are often easier to liquidate than IP. Due to the unique nature of IP, the pool of potential buyers may be more restricted compared to the group of willing buyers for tangible assets.
- IP-based collateralized financing is still considered a somewhat nascent market, and with a limited number of lenders who are comfortable extending loans against IP assets, it can be a more expensive alternative than traditional financing options.
- For an asset to have value, it must be able to be discretely identified. For certain IP assets, there may be difficulty in meeting this requirement. For instance, the success of a product may reflect its use of patents, trade secrets, copyrighted materials, and marketing assets such as trade names or trademarks.

How Companies Can Make Their IP More Attractive to Lenders

Though risks exist with using IP as collateral to secure financing, there are several options a company may consider to reduce these risks and increase the chances of the asset being accepted as collateral. In determining whether a compelling lending opportunity exists, lenders conduct thorough due diligence and borrowers can pre-emptively strategize to position their assets in the best possible light to creditors.

A debtor interested in receiving financing based on an IP portfolio can take extra steps to reduce the risks attached to these assets. Abha Divine, Co-Founder and Managing Director of Techquity Capital Management, LLC ("Techquity"), a company specializing in the monetization of IP and that has been involved in several transactions such as those described in this article, offers valuable insight into how an IP holder can make their IP more attractive to lenders and investors. "[Techquity's] criteria are high-quality assets with no liens and that are unencumbered or lightly encumbered. In order for us to extend financing against it, we need to be the sole and primary security against it." For patent assets, she adds, "We gauge quality based on the fundamental invention, how well the patents were prosecuted, and any validity challenges we may identify. We try to avoid patents that appear to be a late entry to a crowded technology space." Another patent risk to mitigate is invalidity risk and may require, for example, getting an opinion from a reputable IP law firm regarding the validity of the patents, and obtaining infringement enforcement insurance.

As previously discussed, an objective valuation of the IP is critical in the process of securing financing using this asset class as collateral. The valuation should communicate to lenders the key factors demonstrating the full value of the IP to a lender. These factors include the size and growth expectations of the markets for the inventions, the robustness and diversity of the Cash Flow being generated by the IP, the expected future support (cash, technological, or service) required from the IP owner to collect royalties, and potential liquidation value. According to Mr. Peress, the most valuable IP includes assets that can be utilized across several industries or business models. This allows for multiple groups of potential purchasers in the event of default, and is therefore more attractive to potential lenders as it gives them a wider safety net.

A company should be able to provide evidence of the IP assets' potential liquidity. If the asset is revenue-generating, established licensing agreements and financial reports detailing the corresponding licensing revenue demonstrates that the IP is viable and creates income against which a loan can be repaid.

In the event of the asset owner's failure to pay or bankruptcy, lenders need to be comfortable that the assets can be disposed of at a fair price, in a reasonable amount of time, and with minimal transaction costs. Owners are encouraged to provide evidence of use in the marketplace and thus identify potential market buyers. If available, a list of comparable transactions in the marketplace is useful in evidencing demand and establishing pricing expectations to lenders. Borrowers may also want to consider providing potential recovery values for the IP in an event of liquidation. According to Mr. Peress, valuing IP using net orderly liquation value and net forced liquidation value can give comfort to lenders that, in the event of default, an adequate portion of the IP's value is recoverable. Understanding this path to recovery should the borrower default is a critical component of sound underwriting for lenders.

Summary of Article Contributors

The table below contains a summary of the firms highlighted in this article. While this is not a complete list of firms providing services relating to fund raising using IP as collateral, these firms are illustrative of the types of firms involved in this area.

Company	Description	Services/ Products	Website
Carthage Intellectual Capital Management	Carthage specializes in the monetization of IP through sale and license-back arrangements.	IP sale and license-back transactions	http://www.carthageic.com/
Hilco Streambank	Hilco Streambank specializes in appraisals, complex sales, and licensing agreements of IP.	IP transactional and valuation services	http://www.hilcostreambank.com/
M•CAM Global Holdings LLC	M•CAM is a global, full-service intangible asset management firm that provides financial and corporate solutions to businesses of all sectors and public policy advice to governments around the world.	IP collateral enhancements	http://www.m-cam.com/ http://globalinnovationcommons.org/ http://heritableinnovationtrust.org/
Techquity Capital Management, LLC	Techquity is an IP investment firm that partners with IP owners to provide liquidity for their IP through a variety of investment approaches.	IP alternative financing options, particularly for growth capital	http://www.techquitycap.com/

Conclusion

Billions of dollars have been injected into the IP investment market. As the value of IP becomes more widely recognized and IP monetization techniques become more effective, we expect more IP collateralized borrowing deals to be consummated.

This article has attempted to illustrate some of the more common financing methods for companies with valuable IP. Companies wishing to capitalize on their IP should be aware of the different financing options using IP as collateral, the advantages and disadvantages of each arrangement, and how to best position their IP to make it attractive for potential lenders

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