# Nathalia Chavarria Sanchez San José, Costa Rica

**Law student**

The role of Intellectual Property in Finance.

# Abstract

It is a fact that Intellectual Property has taken over many fields in this globalized world; a few years ago, Intellectual Property matters were taken by granted and few people new about the concept, implications, and how involved it would be in our lives. Even though humankind has always been eager to new creations and inventions, the legal protection of the same was not considered as important as it is nowadays. Presently, Intellectual inventions are as appreciated as any other physical or tangible asset; therefore, a wide and complete protection must be provided to fulfil the expectations and necessities arisen.

The role of Intellectual Property in Finance might not be clear in the beginning. One might think that Intellectual Property and Finance are two concepts completely distant; nevertheless, we will see throughout this essay that Intellectual Property and Finance are usually involved in many areas and it’s understanding is essential to the maintenance of a company or business in its daily proceedings.

# The role of Intellectual Property in Finance

1. Concepts

The first step to understand the role of Intellectual Property (from now on IP) in Finance is acknowledge some of the basic concepts of Finance.

What is an asset? Is a resource controlled by an entity (company or business) created of past events (that can be a purchase of self-creation) for which future economic benefits are expected, for example cash, other assets, or reduction in costs. There are three types of asses.

First, current assets are the ones expected to be converted into cash in a short term. They include cash and cash equivalents, accounts receivable, inventory, marketable securities, prepaid expenses, and other liquid assets. Current assets are extremely important to companies because they found day-to-day operations.

Furthermore, fixed assets are projected to be a long-term tangible piece or property, used in the productions of income. They are not expected to be consumed or converted into cash in a term shorter than a year.

Finally, intangible assets~~,~~ are nonphysical property; however, they are as valuable as tangible assets because they have the capability of generating revenue. Intangible assets can be classified as indefinite and definite. Definite intangible assets are for example the branding of the company, if the company continues its operations. A definite intangible asset is for example if a company licenses and has no plans of expansion.

Having a basic idea of what assets are we can now explore IP assets. They are a sub-section of intangible assets. The mayor difference is that these are created and protected by law. They can be identified independently, transferable and have an economic life. Usually IP assets include patents, trademarks, industry designs, copyright, and trade secrets. They can be analyzed under two perspectives, the legal perspective regarding the set of rights granted to the IP holder by the law; and the economic perspective in terms of the benefit linked to the asset.

Why are IP assets so valuable? Their foremost value derives from its ability to exclude competitors from a particular market. Every form of Intellectual Property grants a negative right that exclude other from doing a certain thing. Decreasing costs, enhancing customer value proposition, and increasing the attractiveness of business in and competitive market. IP assets value can be quantifiable regarding the measurable amount of economic benefit to the user and enhancing the value of other assets with which it is associated. The value of an IP asset can be derived from direct use (exploitation), for example launching the product or service using the trademark; sale or licensing the Intellectual Property rights to third parties, and defensive registration (raising value or reducing substitutes). IP Valuation is a very valuable asset due to the future economic benefits it brings; however, the value of the same is determined regarding the circumstances.

It is precise to distinguish the concept of pricing and value. The price of an IP asset represents the amount of money for which the ownership would be exchanged. The monetary

amount at which an IP asset trades in the market. In simpler words: how much is a buyer willing to pay in a transaction based on his perception value of the asset.

The price can be influenced by time, demand, reasons for selling, etc. The value on the other hand, represents the future economic benefits to the IP holder or authorized user. An example for a better understanding of this difference: a patent that is valued in ten million dollars but due to a recession, the owner has not been able to find a buyer for more than eight million dollars; therefore, the price of the patent is eight million dollars. In the past, valuation was usually limited to litigation purposes, for example valuating the damages in an infringement; however, due to the introduction of tax planning involving IP (such as transfer pricing and patent donation) the value became critical to non-litigation circumstances as well. Also, it is exceedingly important for a company to know the market value of an intangible assets in a merger or acquisitions deeds.

There are three valuation methods; the first is through the market, this is the most common and desirable method. Market transactions make the intangible assets comparable. The second method is through income, taking into consideration the future economic utility generated by the intangible assets. And the third component is the estimation of the cost to replicate or reproduce the intangible asset. It is important to take into consideration that there is an important IP valuation gap, this problem has three main components. The first one is that the Internally gown IP Assets are not valued annually nor reported on the financial statements of the company. The only way to report it is when you buy them. The second component that most IP transactions are highly confidential; for example, the patent prices. The third component is that IP Assets are unique which makes it difficult to compare one deal to another, even when data available. 1

1. Innovation and Intellectual Property

Having clear some of the basic concepts, it is also important to make reference to some factors that accompany our main study topic. Innovation implies originality, creation and of course an author of the same. In a globalized world like ours, innovation is key to economic growth and progress towards better tools for our present activities. Intellectual Property encourages innovation and IP rights are mechanism or reward for those who innovate. Without the protections that grants Intellectual Property, innovation would be discouraged and reduced. Innovation drives the focus

from tangible to intellectual assets. Today’s companies, investors and lenders must quickly adopt a culture of considering intangible assets -such as Intellectual Property creations- as viable financing collateral. The concurrent shift from tangible to intangible asset investment can be seen around the word.

The most recent data shows a trend over the medium-term of intangible investment growing faster than tangible investment - in absolute terms: 3.5% CAGR (Compound Annual Growth Rate) and 2.9% respectively. As a proportion of nominal GDP (Gross Domestic Product) both tangible and intangible investment declined slightly between 1997 and 2015. Tangible investment declined at twice the rate of intangible investment (-1.1% per annum for the former, - 0.5% per annum for the latter). In 2008, China raised IP to the national agenda through a National IP Strategy and laid out specific strategies to promote IP, including support for finance to IP-rich companies. The strategy has focused on patents, trademarks and copyright in a number of specific sectors, including: agriculture, national defense, central enterprises, science and technology and media.

In 2014, the State Council reviewed its measures and issued new targets for 2020 to further strengthen the IP system. The plan aims to;

* + Increase the number of invention patents owned per 10,000 habitants from four in 2013 to 14 in 2020
  + Increase the number of registered copyrights of works from 845,000 in 2013 to 1 million in 2020
  + Increase the annual amount of IP rights pledge financing by 2020 to RMB 180 billion (USD 29.3 billion)
  + Increase the transaction value of technology contracts registered on the national technology market to RMB 2 trillion (USD 325 billion). 2

Along with the increase of IP investment in recent years, there has been also growing awareness that IP assets can be monetized. More people and businesses are becoming aware of the ability to monetize IP assets to proceed and sell, license, or use your IP rights as collateral for securing capital. At the present, dealing in intangible assets has allowed rights owners to have easier access to funds. It's also a safer way for them to borrow. IP financing was very common in

the music and film industries, but nowadays this practice is becoming more common in the software and biotechnology industries. With the growing number of financing options, many businesses that may have had trouble in the past with traditional financing find it easier than ever to get the capital they need. The ability to use IP as collateral or auction it off gives businesses the chance to select an option that works best for them.3

It is extremely important to mention that technology is one of the most influent factors regarding economic growth; therefore, intangibles assets have also an essential role in the valuation of an enterprise. The valuation of any type of asset, including IP asset, helps its owner to decide as to the most cost-effective way in which that asset may be used, protected, insured, sold, leveraged or exchanged in the marketplace. Most activities relating to planning, negotiating or managing business relationships or transactions require information on the value of the IP assets of a company.4

1. Intellectual Property Valuation and Finance

IP finance is a very recent concept and due to its very little knowledge it is almost always reserved for formal IP such as trademarks, patents, copyrights, and design rights. The securitization of IP assets has several advantages and disadvantages for companies seeking capitalization. Companies must calculate Intellectual Property into their overall business plans and corporate value proposition to ensure long-term economic success. Four basic structures could be used to monetize the value of your intellectual property: IP-backed loans, IP sale-leaseback, IP legal finance and IP royalty securitization.

The first structure is IP-backed loans. They are helpful for businesses lacking tangible assets or cash flow to support a traditional credit solution. The loans model the structure of conventional asset-backed loans on tangibles like real estate equipment or inventory. Lenders secure a security interest in a company’s IP assets (usually the portfolio as a whole) as collateral for a loan in exchange for interest payments. It is important to note that IP-backed loans amounts are typically determined by the percentage of the IP portfolio’s liquidation value and overall risk as determined by the lender or investor.

3 Upcounsel, “Intellectual Property Financing: Everything You Need to Know.”

On a second place, we have the structure of IP sale-leaseback. It is similar to a real estate sale- leaseback where there is a change in ownership. More specifically, an investor acquires the IP, and the selling company pays a lease or licensing fee. This financing structure provides holders of IP with immediate liquidity with limited restrictions. In most cases, IP sale-leaseback transactions include a repurchase option allowing the seller to buy back the ownership within a predetermined period.

Thirdly, accelerated innovation is quickly correlating to infringements on patents and trade secrets. The IP legal finance structure allows IP owners to advance funds against the future value of their outstanding IP infringement disputes with third parties. In addition to covering general operating expenses, the capital is often used to mount a successful case against infringing parties. Driven by quantifiable outcomes, IP legal finance has quickly become one of the preferred IP financing vehicles for large investors.

On last place, it is important to mention that the number of securitizations using IP as the underlying assets has significantly increased over the years. IP royalty securitizations generally require an IP owner to sell an IP-related income stream for a fixed duration in exchange for a non- dilutive, upfront cash payment. The primary difference between securitization and an IP-backed loan is that the IP owner is not borrowing money but is instead selling a stream of future cash flows.5

1. Advantages of IP Finance

As the world moves deeper into the fourth economic revolution, business success will largely hinge on a company’s ability to produce groundbreaking innovation that caps rising competition. Companies must include a strategic financial partner who understands the IP financing landscape. Properly structured IP financing can fuel a company’s long-term strategic growth and guard its competitive advantage.

The need for monetary valuations becomes particularly relevant when they are used as financial tools by IP holders and as investment assets by financial institutions and venture capitalists. Financial analysts and investors increasingly recognize IP as a key element in the value of a firm and as an indicator of its technological and other capabilities.

For the financial sector, the valuation of a patent is consequently crucial; the lender or investor is only interested in highly fungible collateral. The lender is not interested in using the monopoly right. Its aim is to sell it or to license it. The potential of IP assets to secure financing is a matter of great interest among investors, particularly if supported by reliable and innovative valuation methodologies.

The potential of IP assets as a source of finance is a matter of great interest among investors, particularly if supported by reliable and innovative valuation methodologies. IP assets have therefore been used successfully to leverage capital among different financial players and new instruments of actions are now emerging. There are a lot of advantages in IP Finance.

* + IP finance opens the credit markets for “hard-asset-light” services businesses needing asset-based financing.
  + Under a credit-enhancement structure, IP financing may attract lenders by lowering the borrower’s risk profile if the IP is transferred to a special purpose, bankruptcy-remote investment vehicle.
  + Recapitalization through IP finance can increase liquidity for investment in projects with returns that outpace the cost of financing.
  + Companies may be able to restructure high-cost debt, address liquidity events and prevent equity dilution by utilizing IP financing facilities with attractive terms.6

Intellectual Property can be used as collateral for bank loans. Companies can use their IP assets as loan collateral if they are able to prove their liquidity, value, durability and marketable power. To use IP as collateral it is therefore important to obtain an objective valuation of the identified IP asset. Moreover, the acceptance of IP assets as collateral needs to be supported by respective national laws.

The Development Bank of Japan implemented a loan system that allows the use of patents and patent applications as well as copyrights of computer programs and contents as collateral. Since then, the Bank has granted more than 250 loans to venture firms, with the Bank assessing the present value of the cash flows to be generated by the IP. At present, there seem to be only few banks providing that service as many have difficulties to understand the market of intangible assets and they often take the value of the whole business as collateral from furniture to software

to IP. In financing, banks typically do their own research to confirm that IP has been secured correctly. IP is therefore often seen as an unreliable form of collateral. Commercial banks do not have the necessary competencies to value technology and are generally oriented towards funding projects that have lower risk.

Valuation of Intellectual Property is therefore important because little knowledge about IP and even less experience in valuing and understanding the nature of IP can be seen as key obstacles in access to finance. For the moment, the IP capital market still lacks faith: because of insufficient experience of valuing intangibles, as well as inadequate inclusion of these subjects in training for analysts, there is still little confidence on the capital market in the results of these valuations.

1. Conclusion

Nowadays we are moving towards a more globalized and innovated world. These changes bind companies and startups to valuate Intellectual Property assets, granting them even more importance every time. Even though IP Valuation was usually filled with uncertainty and distrust, recent studies have shown that it a great option to use as much as tangible assets. The advantages of using Intellectual Property are increasing and it has become vital to one and all to understand the terms of the same.

Though there has been much debate lately about the subject, it is clear that betting on intangible assets as a form of finance can help companies and startups upgrade their value. Also, using them as loans, sales or securitizations are now the new forms of monetizing come of the companies worth.

Additionally, it is crucial for the role of Intellectual Property in Finance that the state laws and banks increase and their politics regarding the same. In order to increase the use of intangible assets as capital there has to be a change in the society’s practices and politics to encourage the access of IP in finance.

It is also our responsibility as young lawyers and students to conscientize about recent innovations and focus our attention on new tools that support necessities in this globalized world. We must be part of the change, raise the awareness and knowledge of the use, advantages, and facilities of Intellectual Property in Finance to move as a society towards transformation.

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