Leveraging Software Via The Capital Markets

By Dwight C. Olson and David C. Drews

In Gordon Smith's book "Valuation of Intellectual Property and Intangible Assets," third edition, he discusses that proprietary technology or trade secrets and know-how is often more valuable to an enterprise than its patents. He references Karl Jorda, David Rines Professor of Intellectual Property Law and Industrial Innovation at Franklin Pierce who states, "Patents are but the tips of icebergs in a sea of trade secrets. Over 90 percent of all new technology is covered by trade secrets and over 80 percent of all license and transfer agreements cover proprietary know-how or hybrid agreements relating to patent and trade secrets." Much of those trade secrets are in software processes, products and programs, electronic databases maintained by software, and trade secrets embodied in software. With so much invested in software, how can it be leveraged?

Relatively few organizations appreciate the full scope and flexibility available to them in terms of unlocking the value of their software. Typically, a company seeking financing is looking to expand, acquire another company, refinance or cover seasonal shortfalls in working capital. One of the most overlooked methods for utilizing the value of software is its use as collateral. This activity is becoming more common as the importance of proper intellectual property management gains recognition and as increased cash flows associated with the licensing of intellectual property catches the eye of Wall Street.

There are a number of other reasons why a software owner might be interested in pursuing this kind of strategy. First, it can provide a method for transferring some of the risk associated with receiving future software licensing revenue. If the financing is non-recourse, the risk of receiving the license payments is transferred to the lender. Second, it may increase the return on the software through increased leverage. This is because the present value of impending license streams is being collected in a lump sum today rather than spread out over the future. This lump sum payment can then be invested in current projects that feature an internal rate of return that is higher than the cost of the financing. Any upside potential residing in the software is typically retained by the software owner as well. Third, and possibly the most important, is it provides a source of capital that does not dilute the current equity structure.

With venture capital discounts typically in the range of 25 percent to 50 percent, this is very beneficial when compared to equity sources of financing, especially for smaller technology companies. An additional benefit of this kind of financing is that the interest payments are tax deductible. This helps to offset a portion of the discount taken as a result of the present value analysis.

For the purposes of this discussion, software assets fall into one of two categories: those with specifically identified cash flow from licensing ("Cash Flow Software") and those with implicit value ("Implicit Software"). Cash Flow Software are typically software products or imbedded software that are licensed and producing a revenue stream. With these assets, the license and royalty payments from the license agreements are attributable to the licensed software product or software component. Implicit Software assets will include trade secrets, unregistered copyrights, and software products that are not yet marketed or used only internally.

While many high tech companies invest in Implicit Software, there are few instances of financial institutions lending against software without accompanying license streams. Usually only Cash Flow Software will generate interest from lending institutions. This is because the two primary concerns for the lender are that the funds loaned are secured by "license revenue" collateral and that there is sufficient cash flow available to service the loan payments.

With Cash Flow Software, there are several aspects of this kind of financing that are important to understand. First, the financier is primarily interested in the cash flow: How long has it taken place? Has it been consistent? Is it growing? What are the potential obstacles that may arise? Because the lender is focused on the cash flow and his likelihood of being repaid, it is the credit rating of the licensee that is of importance, not that of the software owner. The licensee is the ultimate source of the cash flow that will be used to repay the loan. In fact, a small entrepreneur that licenses software to a large stable corporation with a great credit rating is likely to get a more favorable interest rate than a more established software owner that licenses to an organization without an exemplary credit history.

Second, lenders will prefer to have the software

assets reside in a wholly owned subsidiary that has a totally separate operation from the software owner. Referred to as a Special Purpose Vehicle or Entity ("SPE"), these holding companies serve to protect the lender against the possibility that the software owner will file for bankruptcy protection. If there is not a SPE already in place, setting one up should be one of the first steps taken.

Third, a trust account will likely be required. Unlike other loans with which you may be familiar, the trust account will remain a vital part of the payment activity throughout the life of the financing. The mechanism is fairly straightforward. All royalty payments made by the licensee are paid into the trust account. From these proceeds, the amount required to service the loan is paid to the lender. Any funds beyond that are paid to the SPE, which may then use them in the management of the intellectual property or may pass them on to the software organization.

Finally, the due diligence agenda associated with this kind of financing is likely to be much more extensive than other lending activities. It will likely consist of legal items such as title searches and software ownership and patent validity, financial items such as valuation and cash flow verification and analysis, and technical items such as obsolescence potential, current and potential competition, and product life cycle. All of these will have to pass a thorough inspection before the financing will go forward.

When financiers lend against Implicit Software or when the license stream is not sufficient to cover the loan payments, lenders need to understand the implicit ownership value of software and mechanisms to secure the software should the lender have to foreclose on the loan.

First, ownership valuation usually comes with an objective, to value and secure a loan. Obviously, in the past most lending organizations were typically reluctant to accept software as a surety. As we know, in order for an asset to be acceptable collateral to a lending institution, the asset must be identifiable and transferable. Other conditions are usually required in order for software to qualify as a basis for financing, as well. A bank would like there to be a market for the technology with an ongoing revenue base of existing clients and the software must be functionally maintained at an acceptable competitive level. In addition, the rights necessary to complete ownership transfer, and the proper materials for use in ongoing maintenance and development, must be readily retrievable and transferable.

In an article written by Priscilla A. Walter when she was at Gardner, Carton & Douglas, "Leveraging Intellectual Property Assets" describes the means of documenting security interests in intellectual property. "These procedures and the collateral preservation procedures enable the lender, in the event of default, to convey the company's assets intact to a third party purchaser," said Walter. The purpose, of course, is to maximize the value of the software, to the advantage not only of the secured lender but also of the other creditors of the company and its shareholders. A necessary step in preserving the value of software is to make sure the software will be available for use, immediately and easily, in the event of a default. It does little good to have an assignment of the copyright in the related proprietary software if the lender does not have immediate access to an up-to-date copy of source code and internal documentation. Rights to copyrights on computer software are to little avail without related engineering and production drawings and clear documentation as to which software is used with other software and hardware to create a releasable and usable product.

■ Dwight C. Olson, Principal, V3Data, San Diego, CA USA
E-mail: dcolson@ix.netcom.com
■ David C. Drews, President, IP Metrics, San Diego, CA USA
E-mail: ddrews@ipmetrics.net

To complement this article, Candace M. Jones, a Partner at Hahn Loeser & Parks LLP, wrote in "The Changing Nature of Collateral: Security Interests in Intellectual Property" (February 2000) at the University of Dayton Law School Licensing Intellectual Property Seminar. "Intellectual property, What is it? How do lenders take and perfect security interests in the intellectual property assets of their borrowers?" asks Jones. The framework for analyzing software as collateral is substantially the same as the analysis for any hard assets of a borrower. First, the lender must identify the software owned by its borrower and determine the ownership value of the software. Then the lender must cause its security interest to attach and be perfected. Finally, the lender should take certain steps, including obtaining certain rights in its security agreement, that will aid in the enforcement of its security interest should the borrower default on its obligations. Software products are potentially protected by four types of intellectual property legal rights: patents, trademarks, copyrights and trade secrets. Some intellectual property rights arise under federal law, and some are created by state law. Similarly, federal law provides some of the rules regarding perfection of security interests in certain

forms of intellectual property, while Article 9 of the Uniform Commercial Code, as adopted by the states, controls in other circumstances. The combination of state and federal laws complicates the process for obtaining and perfecting security interests in intellectual property.

These insights point up one the idiosyncrasies of software: one must have access to both a physical manifestation of all of the components of a software product and the underlying rights to it in order to exploit it. Thus we have seen the emergence of another type of escrow, valuation and audit processes called "Software Collateral Escrow." This is used to implement the requirements outlined above. A Software Collateral Escrow account set up with an intellectual property escrow or trust company, such as Iron Mountain's Intellectual Property Management group, provides the lender with access to all parts of the software asset used as collateral against a loan default. The escrow deposit contains the source code, documentation, firmware, schematics and any other components that the lender needs to secure the technology as collateral. Such Software Collateral Escrow accounts should be verified, validated, and valued. This collateral escrow process and valuation analysis helps eliminate any ambiguity about what the bank really owns and what it might be worth if there is a default on the loan. To assure the lender of its position if the software is covered under copyright, the escrow agreement should include the ability to execute a TX Copyright transfer document. This document will allow the lending institution to take ownership of the technology under default conditions. This is the same process that applies when a bank repossesses a car if the buyer defaults on a loan.

Software valuation provides interesting challenges to the Intellectual Property (IP) appraiser. For any IP valuation company, determining an accurate fair market value of the software in a going concern is difficult enough because it requires an accurate forecast of future revenues and earnings of the company whose software is being valued. However, the lender is not simply interested in the value of the software in the context of a going concern, but in the context of a hypothetical future liquidation as well. This compounds the difficulty of determining a reasonable liquidation value for the software without understanding the makeup of the software for future value.

Intangible assets such as software are usually valued at fair market value. This is the value of an asset to be sold in an arm's length agreement where there is a willing seller and a willing buyer. An asset in liquidation, however, is sold under distressed circumstances, which tend to complicate the typical arm's length transaction. In liquidation, there is usually a severe discount in value from the fair market value of the software in a going concern. With little history to fall back on, the IP valuation company must find new methods to calculate the liquidation value of software that at the time of valuation is still active and viable. It becomes even more imperative that the valuation analysis look at the ownership value of the software as well as its market value. One might look at Federal Accounting Standards Board regulation (FASB) 86 as an aid in understanding software as a financial asset prior to license revenue.

Traditional hard asset appraisers have a distinct advantage over IP appraisers as hard assets have a long history of being liquidated in distress sales. There is extensive data available on the amount of discounting which could be expected for any class of asset sold in liquidation. Conversely, very little data exists on the value of individual intangible assets being sold in liquidation. Usually the intangibles are sold as part of a company sale and, until very recent changes in standard accounting practices, there was no separate accounting of intangible asset values from the overall goodwill booked in the transaction.

Conclusion

Software leveraging is more readily available for strategic use than ever before. Whether the software owner is interested in a straightforward loan using its valuable software as collateral or in securitizing the royalty payments associated with licensed technology, there are mechanisms and options available today that will help to reduce risk, increase return and provide flexibility for the management of intellectual property. ∎