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INTELLECTUAL PROPERTY AND INNOVATION: ROLE OF IP TO RAISE FINANCE FOR START-UPS

COMMUNICATION FROM AUSTRALIA, CANADA, CHILE, THE EUROPEAN UNION, JAPAN, SINGAPORE, SWITZERLAND, THE SEPARATE CUSTOMS TERRITORY OF TAIWAN, PENGHU, KINMEN AND MATSU, THE UNITED KINGDOM AND THE UNITED STATES OF AMERICA

1 INTRODUCTION

1. Imagine that a young PhD student at a technical faculty of a renowned university comes up with a promising invention. Thanks to university modules she attended on how to deal with intellectual property (IP), she applies for and is granted a patent for her invention. Now, together with the university technology transfer office, she would like to bring the invention to market. When writing a business plan, she soon realises that the funds she needs greatly exceed her family's and her university's financial capacity. Where can she find funding? In this very early stage of attempting to commercialise an innovation, investors such as venture capitalists or angel investors might be possible sources of funding and thus can be of considerable importance for a promising start-up.

2. Various studies show that young companies that have an active and a well-managed IP portfolio to show to potential investors obtain more funds and grow faster than those without.[1] So if the PhD student from our example seeks IP protection for her invention, she will stand a much better chance of finding the necessary funds to turn her idea into a business.

3. In addition to protecting intellectual assets from free riders, IP rights are a potentially useful means of raising money, especially for start-ups. In the above example, IP is used as a signal to investors that there is considerable substance in the young company. Furthermore, IP can be used as leverage or collateral for borrowing, or for sale to prospective buyers through sale-leaseback transactions.

2 HOW TO USE IP FOR FINANCING

4. There are different ways to use IP for financing such as:

- IP-backed equity finance[2]

  Young enterprises, especially start-ups without any cash flow, do not usually manage to obtain a loan from a traditional commercial bank. That's why they need partners that invest their own money. Such partners may even become co-owners of the business. In order to convince prospective investors, such as angel investors or venture capitalists, to invest, a start-up has to present a convincing business case. A promising IP portfolio may help to do just that.

- IP-backed debt finance[3]

  IP-backed venture debt is a newer form of financing for young firms in which IP serves as collateral. Whereas providers of equity finance are interested in a company's capacity to

[1] See Haeussler et al. (2012).
[2] See Radauer (2020), p. 193f.
[3] See Baier & Waibel (2022).

grow, providers of IP-backed debt are more interested in a company's ability to pay back its loan.

- IP licensing revenue[4]

  The classic way to generate cash flow from patents, trademarks, copyright and designs is to licence these IP rights, which allows the licensee to use the company's IP. There are various ways of structuring a licensing agreement. For instance, this could involve an exclusive licence or limitations on the circumstances in which the licensee is permitted to use the licensed IP rights. The licences might also be geographically limited.

- IP royalty securitisation[5]

  The idea behind royalty securitisation is that the IP owner transfers the rights to an IP royalty in-come stream for a fixed period in exchange for an upfront cash payment. One example in the area of copyright royalties involves artists who sell rights to the future royalty revenues from their songs or photographs. One well known case involves 'Bowie bonds' in which copyright royalties from album sales and live performances by the musician David Bowie served as collateral for a 10-year bond.

- IP sale-leaseback[6]

  This works in the same way as conventional sale-leaseback procedures, in which real estate may be sold and leased back. Instead of real property, IP rights are sold and then licensed back to the seller to provide the seller use of or access to the IP assets. For start-ups, this kind of IP financing has the advantage of providing immediate liquidity to the seller while still allowing them use of the IP. It is also possible to buy back the IP after a certain period if a clause to this effect is inserted in the contract.

- IP insurance[7]

  Enforcing IP or defending against an IP infringement litigation can become very expensive, and, in most cases, cost-prohibitive for a start-up. In order to prepare for these very real possibilities, companies may take out specialized IP insurance coverage. This IP coverage may be defensive or offensive. Offensive IP insurance will cover the insured's enforcement of its own IP, such as an affirmative IP infringement action. Defensive IP coverage will provide for the defense of the insured against suits alleging IP infringement. This kind of 'IP insurance' may protect start-ups from having to close down their business in the case of a costly lawsuit.

3 INSTITUTIONAL FRAMEWORKS

5. In an interview conducted by WIPO in June 2022 with a representative of Villgro Africa – a Nairobi-based business incubator and early-stage investor focused on health and life sciences – a representative of the business pointed out that loans often do not work for start-ups. The reason for this is that start-ups are small and often do not have enough collateral or revenue to benefit from these types of traditional funding sources. In order to promote innovation, more equity is needed.[8]

6. Some of the requirements for a well-functioning financial IP market and some challenges facing start-ups are listed below.

- Availability of venture capital

  Access to venture capital, and thus to some extent access to IP equity financing, may be limited. The reasons for the lack of venture capital are manifold. An unstable legislative environment, the risk aversion of potential venture capitalists, unfavourable tax regulation, and the absence of adequate IP protection and enforcement are just some of the hurdles that countries may face in attracting venture capital for their innovative start-ups.

[4] See WIPO (2021), p. 39ff.
[5] See Chen (2020) or Espiner (2016).
[6] See Jackson (2022).
[7] See Ozlutrk (2017).
[8] See Omondi (2022).

- Valuation of an IP portfolio[9]

  One of the biggest challenges when it comes to IP financing is the valuation of an IP portfolio. The first question is: What is the value of the IP portfolio of that company? Financial institutions may find it difficult to accurately value IP, and therefore often need to rely on external experts to carry out valuations for them. Start-ups can boost their valuations if they adopt good practices for managing IP. This allows them to better manage, protect and exploit their IP and helps them in the financing process.[10] The second question, which is often even more important for the venture capitalist, is: What is the value of the IP portfolio if the start-up does not survive and the investor has to sell it? This question is directly linked with the next point.

- Transparent and accessible secondary markets for IP[11]

  If investors have to sell an IP portfolio, they depend on there being an accessible and functioning market for IP, as it might be challenging to find suitable buyers otherwise. As in the case of IP valuation, there is a need for specialised service providers – in this case with regard to the buying and selling of IP portfolios.

- Knowledge and awareness of the opportunities offered by IP as collateral for accessing finance[12]

  Last but not least, it is necessary that both the lenders (venture capitalists) and the borrowers (start-ups) are aware of the opportunities offered by IP as a financial instrument. Such awareness is not as widespread as it should be. It is important that start-ups take IP financing into account as a strategic component of their business plans. Likewise, investors need to know the fundamentals of the IP system in order to be able to properly assess the financial risks and opportunities entailed in investing in a start-up and its IP portfolio.

7. This may sound surprising at first, but the first step in the innovation process – having a good idea, developing an innovative product and then protecting the IP – is often easier than the second step – raising the funds necessary to bring the invention to market. A well-managed IP portfolio can considerably help innovators in overcoming this challenge as it signals to potential investors that there is substantial value in the start-up.

4 GUIDING QUESTIONS

a. In your jurisdiction, where do start-ups obtain the funds they need in order to expand and open up new business areas?

b. Do companies and especially start-ups in your jurisdiction use IP financing? If so, what is the most common form of IP financing?

c. Does IP financing in your jurisdiction include entities such as angel investors, venture capitalists, or other sources that are specialised in IP financing, such as equity finance, including public sources?

d. What about IP debt finance? Are there any banks that deal with this form of IP finance?

e. Is IP valuation a service often used by your start-ups and, if so, who provides this service in your jurisdiction? What measures (e.g. programmes, initiatives or guidelines) exist in your jurisdiction to further educate start-ups and investors/banks about IP financing opportunities?

f. What are the key challenges or deficiencies that your delegation sees at the national or international level concerning the role of IP in start-up financing?

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[9] See ICC 2019.
[10] See WIPO (2021), p.19 f.
[11] See Radauer (2020), p. 195 ff.
[12] See Radauer (2020), p. 197 ff.

g. What could be done in your delegation's view to improve the situation?

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