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WHITE PAPER

Leveraging Software Assets Via the Capital Markets

Executive Summary

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. One of the most overlooked methods for utilizing the value of software is its use as collateral. Learn why gaining funding through leveraging intellectual property assets – such as software – is a more readily available strategy than ever before.

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"Patents are but the tips of icebergs in a sea of trade secrets,"[1] states Karl Jorda. He asserts that proprietary technology, or trade secrets and know-how is often more valuable to an enterprise than its patents.

Jorda is a David Rines Professor of Intellectual Property Law and Industrial Innovation at Franklin Pierce Law Center who claims, "Over 90% of all new technology is covered by trade secrets and over 80% of all license and transfer agreements cover proprietary know-how or hybrid agreements relating to patent and trade secrets."[2] Many of those trade secrets are in software processes, products and programs, electronic databases maintained by software, and trade secrets embodied in software.

In this paper, we will explore the question: "With so much invested in software, how can it be leveraged?"

UNLOCKING THE VALUE OF SOFTWARE

Relatively few organizations appreciate the full scope and flexibility available to them in terms of unlocking the value of their software. Typically, a company seeks financing when it is looking to expand, acquire another company, refinance or cover seasonal shortfalls in working capital. However, one of the most overlooked methods for attaining financing is by utilizing the value of its proprietary software as collateral. This activity is becoming more common as the importance of proper intellectual property (IP) 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 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, it **provides a source of capital that does not dilute the current equity structure**. With venture capital discounts typically in the range of 25% to 50%, 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.

TWO TYPES OF SOFTWARE ASSETS

For the purposes of this discussion, software assets fall into one of two categories: those with specifically identified cash flow from licensing, which we will call "Cash Flow Software," and those with implicit value, which we will call "Implicit Software."

Typically, Cash Flow Software consists of software products or embedded 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.

1. Gordon V. Smith and Russell L. Parr, *Valuation of Intellectual Property and Intangible Assets*, 3rd ed., (John Wiley & Sons, 2000)
2. Smith and Parr

Usually Cash Flow Software will generate interest from lending institutions. This is because the funds loaned are secured by "license revenue" collateral, and there is sufficient cash flow available to service the loan payments. While many high tech companies invest in Implicit Software, there are relatively few instances of financial institutions lending against this type of software because it does not have accompanying license streams. However, this is beginning to change.

CASH FLOW SOFTWARE

When using Cash Flow Software as collateral for a loan, 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 software 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.

IMPLICIT SOFTWARE

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

First, ownership valuation usually comes with an objective – to value and secure a loan. 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.

PRESERVING THE VALUE OF SOFTWARE AS AN ASSET

The article "Leveraging Intellectual Property Assets" by Priscilla A. Walter discusses the means of documenting security interests in intellectual property. "These procedures and the collateral preservation procedures are designed to enable the lender, in the event of default, to convey the company's assets intact to a third party purchaser. The purpose, of course, is to maximize the value of the business, to the advantage not only of the secured lender but also of the other creditors of the company and its shareholders. The final step in preserving the value of an intellectual property intensive business is to make sure the intellectual property 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 a database and the related proprietary software if the lender does not have immediate access to an up-to-date copy of both the database itself and the software, including source code and documentation. Rights to patents and copyrights on computer software are to little avail without related engineering and production drawings, as well as clear documentation as to which software is used with which hardware to create a product."[3]

To complement this article, Candace M. Jones wrote an article on "The Changing Nature of Collateral: Security Interests in Intellectual Property," in which she states, "Intellectual property. What is it? How do lenders take and perfect security interests in the intellectual property assets of their borrowers?"[4]

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.

SOFTWARE COLLATERAL ESCROW

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 a type of escrow, valuation, and audit processes called "Software Collateral Escrow." A Software Collateral Escrow is used to implement the requirements outlined above. A Software Collateral Escrow account set up with an intellectual property escrow or trust company 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.

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3. Pricilla A. Walter, "Leveraging Intellectual Property Assets," *The Lawyer's Brief* (Vol. 20, Issue 21), 2-6, September 1990
4. Candace M. Jones, "*The Changing Nature of Collateral: Security Interests in Intellectual Property*," presented at the University of Dayton Law School Licensing Intellectual Property Seminar, February 2000

Such a Software Collateral Escrow account 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.

A REAL-LIFE EXAMPLE

The technology lending arm of a large U.S. bank is using technology escrow and verification services today, in the method described above, to secure loans to software developers. Many times, it is difficult for a software developer – especially a smaller developer – to secure funding to invest in the development of new products or further the development of existing products. Since these software developers often do not have the tangible collateral needed to secure funding, the bank has worked with software developers to leverage the value of their intellectual property assets.

This particular lending institution identified a need which they satisfied with technology escrow and verification. The example below highlights how the industry is evolving to a sophisticated software collateral escrow which will deal with the evaluation of the many asset components of software of which source code is just one. In a technology escrow, the escrowing of the verified or proven source code provides the beginning steps necessary to secure funding. This bank turned to Iron Mountain, the leader in technology escrow, to act as the neutral third party to verify, manage and secure the source code asset.

To execute this type of source code arrangement, the lending or funding institution, the developer, and the escrow agent all enter into a tri-lateral escrow agreement. An overview of the agreement and the process is outlined below.

- The escrow agreement requires the developer to deposit the source code for the product(s) that are securing the funding with Iron Mountain at regular intervals and includes updates, changes, patches, new releases, etc.
- Once the initial deposit is received, Iron Mountain's team of software engineers takes the source code, any third party tools, and the build instructions and works to rebuild the code based on the information provided. In the majority of cases, Iron Mountain needs to go back to the developer for additional information due to steps in the rebuild process that are easily forgotten and not noted in the build instructions. Iron Mountain documents or enhances the existing documentation every time additional steps or processes are discovered.
- Once Iron Mountain has successfully rebuilt the code, the new fully documented, complete version of the source code, third party tools, and build instructions are deposited into escrow, and the funding arrangement can move forward.
- The agreement requires Iron Mountain to hold the initial deposit and all subsequent deposits in its secure facilities until either the parties jointly request termination of the escrow agreement (the financing agreement terms have been met and escrow is no longer necessary), or a trigger condition occurs (as specified in the escrow agreement) that requires Iron Mountain to release the code.

The value to the bank is that they now have a financing agreement that is secured with source code they know could be usable or saleable in the event of default by the bank's customer. Additionally, the bank is able to justify the lending money to its board, since it is collateral-backed lending. With the emergence of the Software Collateral Escrow (SCE), all software components (including source code) necessary to bring a software product to market are collateralized, valued, verified and escrowed. This new SCE service offering provides for a more "saleable" assets situation.

THE VALUE OF INTANGIBLE SOFTWARE ASSETS

Valuation of intangible assets, such as software, is needed for the lender to feel comfortable that the assets they are lending against are viable. Properly identified and valued software product components also help the borrower secure more funding. Software valuation provides interesting challenges to the Intellectual Property 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. Fair market value 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 components of the software as well as its market value. One might look at Federal Accounting Standards Board (FASB) Statement 86 as an aid in understanding software as a financial asset prior to license revenue. This investigation will lead to other software components than just source code necessary to treat software as an asset. The software collateral escrow will be the vehicle to value, analyze, verify and escrow the components.

Within their area of expertise 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 almost any class of hard 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 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.

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