Financial First Aid for the Research and Development of Intellectual Property Assets

by Beverly A. Berneman

Consider what was the standard scenario for a client who was in the process of developing a new product. The client goes to a bank and the bank conducts a due diligence search. If the client has enough hard assets, the bank approves the loan in exchange for a security interest in the hard assets. This type of asset-based lending results more from the bank's comfort than the client's needs.

Not to give the impression that asset-based loans were plentiful and obtainable in all instances. When intellectual property assets—namely, patents, copyrights, trademarks, and trade secrets—make up the bulk of a client's assets, asset-based lending could never quite find a comfortable position. Intellectual property assets have two qualities that would put off any risk manager. The alchemy of valuing intellectual property assets creates uncertainty as to the true value for funding purposes. Additionally, should a borrower default, banks had the problem of how to foreclose on the asset, sell it, and realize value to apply to the loan.

By contrast, in the current economic climate, asset-based lending is hard to find for everyone. Yet, innovation and product development continue. Clients with great ideas and the energy to develop and market them need funding. Non-asset-based lending can be an alternative for these clients.

This article focuses on financing the various initial phases of the development of emerging companies. The article proposes a flexible approach for companies whose primary assets consist of intellectual property such as patents, copyrights, trademarks, and trade secrets. Different methods of financing will be appropriate for different phases of the company's growth. In order to properly prepare for financing the mature stage of growth, the emerging company must plan ahead. Financing opportunities at the initial phase of growth must not foreclose financing opportunities at the mature phase of growth. Therefore, we will examine the various phases of an emerging company and its financing opportunities in each.

Phases of Initial Development and Funding Sources

The Embryonic Phase

Idea Development Drives the Embryonic Phase

Every business starts with an idea for a product or service. During this embryonic phase, the entrepreneur takes the idea from a hazy concept to a fully formed potential product or service. Creativity abounds. The entrepreneur explores different permutations of the idea to develop a marketable product or service.

Many entrepreneurs want to brainstorm with others to fully flesh out the idea. Some bounce the idea off of friends and family. Some seek mentorship through colleagues and associates. Others convene an advisory board for brainstorming.

Image: Getty Images

Brainstorming can cover limited topics such as investigating technological issues or barriers to producing a workable product or service. Brainstorming also can include marketing, competitive obstacles, and practicalities. The cautious entrepreneur will require confidentiality of all discussions regarding his or her idea.

The embryonic phase holds pitfalls for collaborating groups of entrepreneurs. When entrepreneurs collaborate, they often pay more attention to the development of their idea than to their relationship. Despite their hyperfocus on the venture, this phase offers the best opportunity for a collaborative group of entrepreneurs to determine their business structure. During the embryonic phase, the spark of creativity and potential holds unlimited possibilities. The collaborating entrepreneurs have come together in this spirit of potential. They "feel the love" for one another and for the future success of their idea. Yet, failure to solidify their rights, duties, and expectations at this phase could cause a collapse of the business in the future. Too many collaborating entrepreneurs ignore this important component of their future business together. If the idea never gets beyond the initial phases, a written agreement among the collaborators will make little difference. However, if the idea becomes highly marketable and lucrative, the parties could come into conflict regarding the nature of their relationship. The success of a venture acts as a barometer of the extent to which parties remember, misremember, or even fabricate the components of the original agreement among them. The courts have a surfeit of lawsuits involving disputes among business originators. As the venture becomes more and more successful, memories fade. As memories fade, the collaborating entrepreneurs may have differing views of the original understanding among themselves. Therefore, collaborating entrepreneurs should seek early advice from professionals to determine, solidify, and formalize their relationship.

The resources needed for this phase tend to be minimal. During the embryonic phase, the enterprise may not need to rent space and purchase equipment. Idea development can take place in a home office, garage, or basement. The primary concern revolves around protecting the idea or concept. Thus, methods to protect confidentiality will need an outlay of funds. Additionally, fees to paid consultants may require a minor outlay of funds.

Funding Resources for the Embryonic Phase Stay Close to Home
The financing resources for the embryonic phase will usually come from either the entrepreneurs or sources close to them.

Personal Resources. The entrepreneurs will generally first look to their own resources such as disposable income, savings, sweat equity, and borrowing from retirement funds. Most entrepreneurs will have some disposable income and personal savings. These resources tend to be limited and quickly exhausted.

Sweat equity assumes that the new venture has its own source of funds outside the development of the new product or service. This often occurs when an entrepreneur has been servicing one channel of trade, geographical area, or market and seeks to expand. However, sweat equity may put the revenue from a successful product or service line at risk if the new market fails. Funneling "good money after bad" can cause the demise of an otherwise successful venture.

Borrowing from an individual's pension fund also has advantages and disadvantages. Pension funds offer an accessible source of funds with very few obstacles. However, the use of pension funds also offers two primary disadvantages. First, while the funds remain in a non-self-directed pension account, they are exempt from claims of creditors. Removal of the funds transforms them from exempt assets to nonexempt assets. For entrepreneurs with a troubled personal financial status, the conversion of funds to nonexempt assets may not be appropriate. Second, the Internal Revenue Code has specific rules regarding payment of interest and repayment of funds into the account.

Family and Friends. Family and friends can be a good source of initial "seed money" for the emerging company. The entrepreneurs would be well advised to document the circumstances of the transfer of funds. The entrepreneurs also should be cautious about making promises. The expectations of the relative or friend should be examined in detail. The parties should ask themselves pertinent questions regarding the financing relationship such as:

- Does the relative or friend expect anything in return for the funds?
- Will the funds be a loan or a gift?
- Will the relative expect to become an equity security holder in the business organization?
- Will the relative or friend expect to have control over the venture in any way?

In order to protect all of the parties involved, expectations should be memorialized in a written agreement.

At this point, the entrepreneurs should plan ahead for future sources of financing. If the entrepreneurs intend to rely solely on friends and family, then the creation of a limited liability company might be the best way to obtain financing without diluting management and control. With a limited liability company, the entrepreneurs should determine the funds needed for the entire enterprise. Then membership shares can be valued accordingly. A typical membership agreement also can address the workings of the enterprise from its inception and onward. The membership agreement can solidify management and control of the venture. It also can control the sale of membership interests and their hypothecation. However, if the venture will eventually look to institutional funding sources such as venture capital or asset-based lending, the limited liability company may not be appropriate. Dilution of

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ownership may foreclose obtaining venture capital and asset-based financing in the future.

Ultimately, the embryonic phase can be used as a place for planning and growth. With ultimate goals in mind regarding business structure and financing, the entrepreneurs' immediate decisions become easier. Proper planning at the embryonic phase can create a solid foundation for the future of the endeavor.

Start-Up Phase

The Start-Up Phase Begins After Completion of the Foundation Work During the Embryonic Phase

By the time that the start-up phase begins, the entrepreneurs should have formed their business structure. All of the foundation work should be complete. Questions regarding fostering the idea have been answered. Definitive agreements defining the relationship between collaborating entrepreneurs should be in place.

At this point, the entrepreneurs must transform themselves from idea originators to businesspeople. Creativity must make room for sound business decisions. The best ideas can be lost in failure due to lack of infrastructure.

Most emerging companies find this juncture the perfect time to develop a business plan. The business plan should provide a guide through the start-up phase and beyond the growth phase.

The plan should cover everything from an analysis of the company's goals to market research and on to production and marketing. Chief among the components must be a financial plan. The financial plan should outline the venture's current and future needs. Underestimation of financial needs can strangle a venture at a critical juncture.

Retention of a professional to develop a business plan may be costly. However, professional business plan development can save money in the long run by properly anticipating future goals and financial needs. During this phase, innovation and growth of the idea will spur the emerging business.

During the start-up phase, entrepreneurs could spend considerable time on research and development of the idea. Intellectual property assets will be developed. Prototypes will be created and tested. Protection of intellectual property assets as they are being created becomes critical to the future success of the company.

Market research helps the entrepreneurs assure a place for the product and service in the marketplace.

The start-up phase is the perfect time to develop a business plan, which should provide a guide through the start-up phase and beyond the growth phase.

Funding Resources for the Start-Up Phase Must Come from New Venues

The start-up phase often sees the venture in a financing limbo. Initial funding for exploration may be exhausted. Personal resourses, family, and friends may continue to be a source of funding; however, they often cannot be relied upon for long-term financial support. Institutional funding resources (which will be discussed later) generally shy away from companies in the start-up phase. The unavailability of institutional funding, even in a good economy, results primarily from governmental oversight and internal safeguards against risky investment. However, the following nontraditional funding resources may be available.

Business Structure. Business entity structure can provide a source of funding. Upon formation of a corporation or limited liability company, shares or membership interests can be pre-subscribed or sold. Of course, the sale of shares or membership interests will dilute the ownership framework of the company. However, with careful long-range planning, the managing entrepreneurs can protect their control over the venture and still make the company an attractive investment.

Angel Investors. Angel investors have resources and willingly take on riskier ventures. The concept of angel investing began in theater production but has now taken hold in the general business community as well. Angel investors often have worked in the industry as top executives and use angel investing as a retirement strategy. They tend to be wealthy individuals with an interest in business development in a certain industry. Groups and networks of angel investors also have developed recently. In exchange for investment, the angel investor will often seek either a percentage return on investment or an equity stake in the venture. Finding angel investors can be the most difficult part of securing this form of financing. Brokers offer help finding angel investors; however, entrepreneurs should be wary and properly investigate brokers who promise to find angel investors. Many brokers may promise much and deliver very little at a high cost. Thus, the wary entrepreneurs should ask for references and investigate the broker's past successes.

Small Business Administration. In more robust economies, banks offer to underwrite small business administration (SBA) loans. While SBA loans may be difficult to achieve in today's economy, the entrepreneurs should at least explore their availability. SBA loans often require guaranties from individuals involved in the venture. Even if initial inquiries with financial institutions are unsuccessful, the entrepreneurs should continue to revisit the issue as the venture becomes more viable.

Strategic Alliances. Entering into strategic alliances with suppliers and vendors also may be a source of revenue. Strategic alliances also allow ventures with complimentary innovations to create a product together. For instance, a social networking website that concentrates in a certain area of interest may want to collaborate with an emerging online store selling relevant products. Unlike a partnership, a strategic alliance allows two entities to join forces for their mutual benefit. Each party relies on the other to fund its own innovation. The strategic alliance has sufficient flexibility to address the needs of each party.

Due to its flexibility, the parties must put their agreements in writing in order to preserve the relationship. At a minimum, strategic alliance agreements should cover: (1) the contributions of each party to the alliance, (2) the ownership of intellectual property and other assets, (3) the ownership of intellectual property created during the alliance, (4) each party's burden as to the expense of the alliance, and (5) each party's distribution of the profits from the alliance.

Credit Cards. Many entrepreneurs will rely on credit cards for funding at this point. This type of financing must be used with extreme caution. Credit cards carry high interest rates. Even the most successful organization can be crushed by the need to repay credit card debt. Further, most corporate credit cards require individual guarantors. The financial burden becomes the burden of the individuals and not just the company. The company's financial burden then becomes the financial burden of the individual entrepreneurs and their families.

Thus, during the start-up phase, the emerging organization can find funding through both traditional and nontraditional sources.

Growth Phase

The Growth Phase Nurtures the Development of the Organization as It Begins to Generate Revenue

During this phase the organization releases its product into the marketplace. The organization deals with a range of issues that demand time, energy, and revenue in order to sustain its potential growth in the marketplace. The organization begins to bring in revenue. In all but rare circumstances, the revenue does not yet cover expenses. Therefore, the organization still needs financing to continue operations.

This phase presents the best opportunity to prepare for more substantial financing options. The organization can now approach more traditional and higher-level funding sources. However, the sources will demand a higher level of disclosure from the organization.

Preparation for the requirements of the more "high-end" funding sources begins with a revised business plan. The original business plan must be reexamined to ensure it reflects what the entrepreneurs have learned during the embryonic phase and the start-up phase. Research and development of the product and service often changes the original focus. The marketplace may have changed or adjusted. All variables should be reevaluated.

Due diligence becomes another key component of preparation. Especially during the start-up phase, growth and innovation sometimes give way to the formalities of an organization's growth and protection of its assets. All "high-end" funding sources will conduct their own due diligence. Therefore, an organization would be well-served to investigate and answer due diligence questions for itself before presenting itself to a funding source. At a minimum, due diligence should include: (1) an assessment of the strength of the operation, (2) an asset audit that includes inventory and ensuring that the organization has documents of title, (3) valuation of the assets, (4) the state of the current market for the goods or services and the impact that the goods and services will have on the market, and (5) evaluation of key personnel and their incentive to stay with the enterprise on a going-forward basis.

Funding Resources for the Growth Phase Expand to Institutional Venues

During the growth phase, available funding sources expand. All of the funding sources discussed in the other two phases are still available at this phase. However, as the organization begins to generate revenue, more traditional institutional funding becomes available.

Venture Capital. During the growth phase, venture capital becomes a viable funding option. Venture capital funds the operation in exchange for an equity position in the company. Venture capitalists tend to lend to specific industries or geographical areas. An organization seeking venture capital must have some operating history to establish its viability. While venture capitalists are willing to accept risk, they will conduct extensive due diligence before advancing any funds. The organization should carefully review any agreements with a venture capital funding source. The organization should review the agreement keeping its ultimate goals in mind. Evaluation of its assumptions and expectations will affect the place that venture capital has in the growth of the organization.

Asset-Based Financing. Asset-based financing also may become available during this phase. Asset-based financing comes primarily from banks and finance companies. Most asset-based financing relies heavily on tangible assets. Many lending institutions view intangible assets such as intellectual property as an afterthought. Therefore, an organization whose primary assets are intellectual property may find it difficult to secure asset-based financing.

In a more robust economy, this may change. The acceptability of nontraditional business models continues to grow. The success of Amazon, Facebook, and Google cannot be ignored. As this trend grows and credit becomes more available, lending institutions may become more amenable to investing in organizations with primarily intangible assets.

Conclusion

A sluggish economy does not hinder entrepreneurial drive. Entrepreneurs, inventors, writers, artists, and creators of all varieties will continue to innovate. Innovators will need funding to get their ideas to market. While a sluggish economy will not hinder the spirit of the entrepreneur, it will hinder getting ideas to market. Entrepreneurs need a source of funds to develop their innovations from experimentation to prototype development to manufacturing and marketing. With proper planning, the entrepreneurs will have a wide range of available sources for funding at the various phases of development. ■