

Intellectual Property – A Financing Mechanism For Start-Ups?



iLINC
ICT Law Incubators
Network

Within the Information Society, the value of a start-up does not depend on its physical assets. On the contrary, intangible assets, such as intellectual property (IP) are crucial elements for start-ups when they wish to establish a competitive market position. In the start-up stage, the value of IP is potentially higher than any other business asset.¹ Moreover, IP creates opportunities, both from a marketing and financing perspective. IP can generate income through licensing, the sale or commercialization of IP-protected products. Additionally, the smart and efficient use of IP can enable a start-up to increase its market share or to raise profit. Furthermore, investors are on the lookout for valuable intellectual assets.² In order to fully capitalize on this potential, protection has to be sought. If intellectual assets enjoy legal protection, their quality is secured, which in turn minimizes the investor's risk. This legal protection is granted by Intellectual Property Rights (IPR): they provide their owner the exclusive right over the use of his creation during a limited period of time.

Start-ups, IP and Investors

A well-managed IP portfolio is key to investors. The strength of a start-up's invention or innovation and the ability of that start-up to commercialize it, is important to investors.³ As mentioned, they will want to minimize risk and maximize returns. Intellectual assets will first have to be evaluated. Therefore, investors must take into account the risks involved. These could be market, financial, management or technological related, but the legal framework plays a crucial role as well.³ A venture capitalist will evaluate the security of the intellectual property. As such, they will examine whether the intellectual assets claimed to be owned by the start-up is protected by IPR.³ Well protected IP safeguards quality and is indicative of the start-up's potential in the marketplace.

The value of a start-up's IP will nevertheless depend upon the chosen valuation method. Some are market driven, while others will focus on the cost or look at the potential income that may be derived from the IP.⁴ Start-ups may want to perform an IP audit, taking into account these factors.

How IP protection mechanisms contribute to the start-up's financial

IPR cover a broad spectrum of rights. However, each of them differs in purpose and scope. Databases, inventions, brands, designs, innovation. All can be protected by IPR. For a start-up, it is necessary to understand how different types of IP can contribute to its overall value. In this brief, we

will focus on those types of IP that are particularly useful for start-ups: trademarks, patents and trade secrets.⁵

Patent protection and investment

Patents are exclusive rights that are granted for inventions, regardless of the field of technology. Both production methods and products - or a combination of both - can be the subject of patent protection, which may last 20 years. In order to enjoy patent protection, the invention must be new, involve an inventive step and be susceptible of industrial application. Due to the exclusive nature of the patent, others are prevented from using the invention, unless prior permission is obtained. This can safeguard the start-up's market position and provide a competitive advantage over rival undertakings. The development of innovation requires time. R&D can be cost-intensive as well. By using the exclusive right, these costs can be recovered: the patent owner is the only one that can exploit and market the invention. Filing for a patent in multiple countries may also act as a gate-way to new markets.⁷

A start-up's innovation and market performance can be measured via patents. Consequently, a strong patent position is highly desired by investors³.

Despite their benefits, filing for patent protection may not always be the best strategy. Even though an exclusive right will be obtained, in return, the technical details of the invention have to be fully disclosed to the public. Moreover, a patent may be expensive to obtain and maintain, even if licensed. Finally, if there is an infringement, litigation costs can be high. A start-up will thus have to determine whether the advantages outweigh the costs. This decision should be primarily based on the commercial viability of the innovation. A careful assessment will be required, taking into account the following: Can the invention be licensed? Do investors show interest? Can competitors design around your invention? Can the patent be easily infringed, and can these violations be detected and enforced?³ In rapidly evolving technology sectors, wherein most start-ups will operate, an innovation may be patentable, but if it is only incremental, competitors may be able to design around and improve it.

Trade Secrets

Confidential technological and business information may already provide start-ups the advantage they need. Trade secrets don't provide formal protection, but they do offer some benefits over the formal IP route. For instance, trade secrets are not limited in time. On the flipside, protection will only last as long as the secret is kept. Financially, secrecy isn't subject to filing or registration costs,

nor is 'protection' dependent on such formalities. Moreover, in the early stages of development, secrecy may be the only viable option, as the innovation could be deemed non-patentable.

Still, little actual protection is available once the trade secret has been disclosed to the public. As soon as a product launches, everyone can uncover what has been hidden by his competitor. Others could reverse engineer the product, without there being due recourse. Additionally, the lack of an exclusive right, enables third parties to make use of that innovation. Once uncovered, competitors could even apply for a patent themselves, because most often there would have been no disclosure of the invention.²

Trade secrets may also not be the best means to attract investment. The trade secret has to be disclosed in some way in order for investors to buy into the potential it may bear. Confidentiality agreements do allow for protection, but venture capitalists and angel investors are most often unwilling to sign non-disclosure agreements (NDAs). Having to listen to hundreds of ideas on a daily basis, an overreliance on NDAs would 'box' their operations.⁹ Moreover, enforcing these agreements may be a costly affair. Instead, it may be better to build relationships of trust. Nevertheless, investors may prefer a trade secret over a weak patent. As they want to minimize their risk, they may be reluctant to finance a start-up that is threatened by costly patent litigation.³

Trade Marks

Trademarks provide legal protection for any sign that is capable of being represented in a clear and precise manner (e.g. words, logos, designs, shapes, packaging, colours and sounds) and that is capable of distinguishing the goods and services of one undertaking from those of others. A trademark thus provides its owner legal certainty when branding the products of its undertaking. Moreover, due to their capability to distinguish, trademarks can bear tremendous value for start-ups. Not only from a marketing, but also from a financing perspective. As trademarks represent the reputation and qualities associated with the marketed product, a trademark with a high distinctive character or reputation can certainly provide a market advantage.¹⁰

A strong (and well-protected) trademark may also impact the chance of attracting funds. Consumer trust influences revenue. Trademarks can also be indicative of one's effort to build consumer brand awareness. Furthermore, trademarks can be licensed, franchised or marketed. As branding contributes to a business's success, brand management may positively affect an investor's

appreciation of the start-up. Studies do indicate that trademarks not only have a protection value, but that they also serve as a signal for investors. In the start-up sector, studies have shown that trademarks can be strong predictors of venture capitalists' valuation.¹¹

Open Innovation

Open innovation stems from the belief that the widespread nature of information and knowledge has made it increasingly difficult for undertakings to solely rely on internal R&D for their innovations.¹² Instead, start-ups should examine the option to buy or license technologies from other parties. Alternatively, internal IP that has little value for the start-up could be offered through licensing, joint-ventures or spin-offs.¹³ Open innovation thus opens up alternative prospects to generate revenue. An open approach to innovation may enable a start-up to build up a larger network around them. Consequently, becoming part of a large network may allow costs for R&D to be shared. Although open innovation may require start-ups to give up a part of their independency, the support gained from surrounding undertakings may very well aid start-ups that seek funding or financial stability.

References

1. Petr Hanel, 'IPR Business Management Practices: A Survey of Literature', *Technovation* 26 (2006).
2. WIPO, *Intellectual Property for Business*.
<http://www.wipo.int/sme>
3. Mario W. Cardullo, P.E., 'Intellectual Property – The Basis for Venture Capital Investments'.
http://www.wipo.int/sme/en/documents/venture_capital_investments_fulltext.html#P8_90
4. PWC, 'IP valuation, Exploitation and Finance' (WIPO workshop on effective intellectual property asset management by SMEs).
5. Science/Business, 'Small Companies, Big Ideas: How Intellectual Property helps SMEs Grow' (2014).
6. European Patent Convention.
7. WIPO, 'Inventing the Future: An Introduction to Patents for Small and Medium-Sized Enterprises' (*Intellectual Property for Business* 3, 2006).
8. WIPO, 'Patents or Trade Secrets?'.
http://www.wipo.int/sme/en/ip_business/trade_secrets/patent_trade.htm
9. Eric T. Wagner, 'Entrepreneurs vs. Venture Capitalist: The Curse of the NDA' (*Forbes*, 27 August 2013).

<http://www.forbes.com/sites/ericwagner/2013/08/27/entrepreneur-vs-venture-capitalist-the-curse-of-the-nda/>

10. WIPO, 'Making a Mark: An Introduction to Trademarks for Small and Medium-Sized Enterprises' (Intellectual Property For Business 1, 2006).

11. Joern H. Block, Geertjan De Vries, Jan H. Schumann and Philipp Sandner, 'Trademarks and venture capital valuation' (2012).

12. Alexander Krasnikov, Saurabh Mishra & David Orozco, 'Evaluating the Financial Impact of Branding Using Trademarks: A framework and Empirical Evidence' *Journal of Marketing* Vol. 73 (November 2009).

13. Karri Leskinen and Sampo Yläatalo, 'Open Innovation' in Adam Jolly and Jeremy Philpot (eds), *The Handbook of European Intellectual Property Management* (Kogan Page 2009).

ILINC is the European Network of Law Incubators. Its main objective is to facilitate the provision of free legal support to start-ups while, at the same time, offering postgraduate law students the opportunity to engage in professional practice in the fast-moving and highly exciting world of technology start-ups.

Visit us on our website:

<https://www.ilincnetwork.eu/>

Our core partners:

