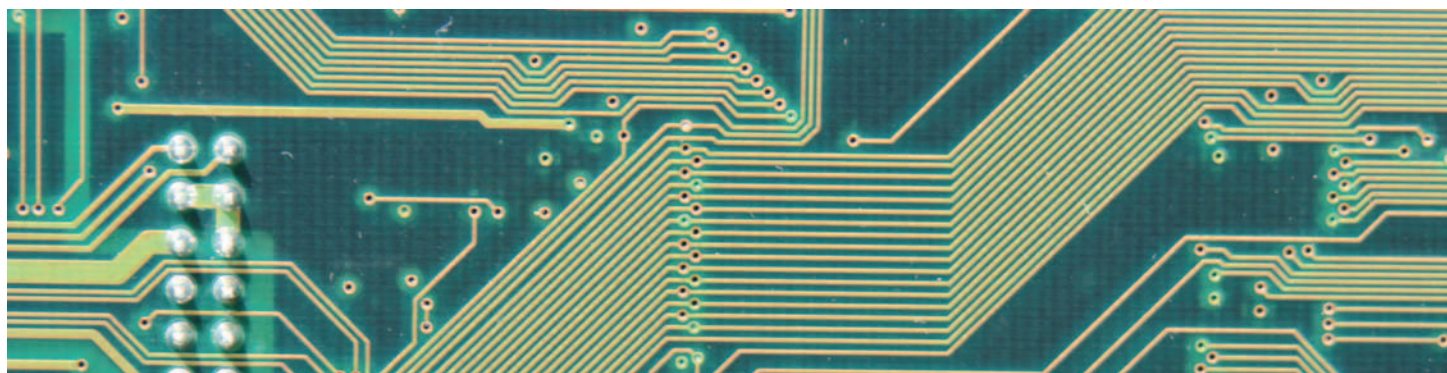


TECHNOLOGY AS COLLATERAL IN VENTURE FUNDING

By John Boruvka



How can a start-up company secure financing using its technology as collateral? It is possible, but banks are typically reluctant to accept this asset as a surety.

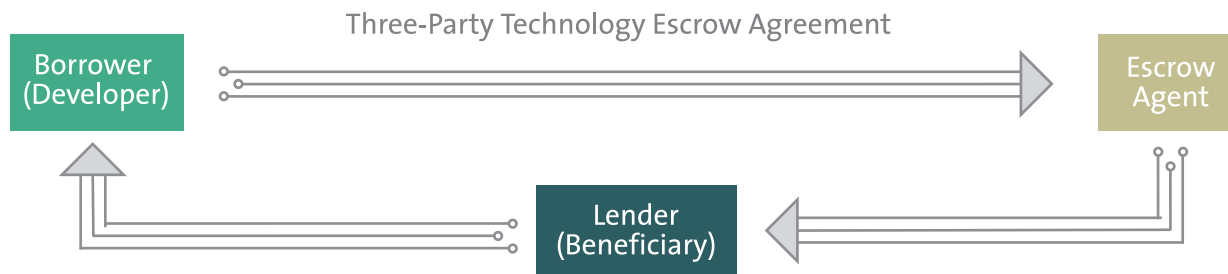
Emerging technologies are on the horizon, attempting to push the boundaries of how we accomplish a certain task, fix a particular problem or create better processes in the future. At the heart of each emerging technology is some form of intellectual property (IP). Intellectual property is a critical piece of every emerging technology company because it embodies the underlying value behind the fledgling enterprise's competitive advantage. The company's value is intrinsically tied to its intellectual property whether it is software, hardware, secret algorithms or formulas.

When an emerging technology company seeks funding, its primary assets are in the form of IP and the founding team's know-how. Start-up companies that want to secure funding are essentially using their technology and intellectual property as collateral. This IP is the collateral that secures the developer/lender relationship.

The economic value of intellectual property has also increased dramatically as compared to tangible assets. As stated in a speech on Intellectual Property Rights given by Alan Greenspan at Stanford in 2004, "Over the past half-century, the increase in the value of raw materials has accounted for only a fraction of the overall growth of the U.S. Gross Domestic Product (GDP). The rest of that growth reflects the embodiment of ideas in products and services that consumers value."

When venture capitalists make investments in emerging technologies and the companies behind them, they know that a certain percentage of those investments will fail. Whether it is angel financing, Round A or Round B venture funding, it makes sense for investors to require access to the underlying intellectual property on which the company is based.

In the event that the company does not succeed, the venture capital (VC) firm now has options. They can take the IP assets and find someone else to further develop that IP, or they can mitigate their losses by selling off the IP assets. Access to the intellectual property can be set up using a technology escrow agreement between the lender, the company, and an independent, third-party escrow agent.





Technology escrow is the practice of securing access to the intellectual property, often software source code, and any other proprietary materials – such as design schematics, manufacturing processes, supplier information, and third party tools – necessary to recreate the product in the absence of the supplier.

Acting in this intermediary role, the third party escrow agent maintains the integrity of the developer's intellectual property while ensuring lenders have access to those assets under specific, controlled circumstances. The result is increased control and leverage for all parties, enabling the lender to protect itself, while safeguarding IP assets for the emerging company.

To ensure the completeness and validity of the deposit materials, the lender should also require validation and verification of the deposit. After the verification is complete, the escrow agent will request and receive periodic updates to the collateral deposit. In order to continually assure the lender that the deposit will have value, the escrow agent will document and report all update activity on the account to the lender.

In essence, technology escrow helps both the borrower

and the lender as they work together. The borrower wants to leverage its IP to obtain funding, and also wants to protect its IP rights and minimize unnecessary disclosures. With technology escrow, it can establish an IP protection strategy and methodology to identify, capture, protect and maximize IP assets.

At the same time, the lender wants to protect its investment. Technology escrow provides a means to the borrower's intangible IP assets by providing a process for identifying, cataloguing and continually establishing a tangible form of identification. This gives the lender leverage to access the "complete" product for resale if needed. With a trusted escrow agent and legal counsel, the lender can set up the means for timely access to a current, complete set of collateral materials with access to ownership and legal rights.

In the decade following the .com bust, most emerging companies are depending on private equity for a much longer period of time before considering an initial public offering (IPO). As companies remain venture funded, VCs should look at the intellectual property and know-how behind their investments, and consider implementing technology escrow as leverage when negotiating funding. //

