

# **Intellectual Property – The Basis for Venture Capital Investments**

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While technology has been seen as one of the engines for the dramatic economic growth and productivity the United States has experienced over the last several decades an underlying factor has been the strength of the intellectual property developed during that period. It is the intellectual property that provided the basis for investors to place their resources at risk. Intellectual property is an integral part of value creation in a technology-based enterprise and as such is a critical element in obtaining venture capital for SMEs. The appropriate use of the intellectual property system is a powerful tool for competition, stability and mitigation of risks on capital investments.

## **Venture Capitalists and IP rights**

One of the major problems faced by new technology seed and start-up enterprises is access to the first round of funding, either through debt or venture capital investment. Venture capitalists want to know where an invention or innovation fits in the marketplace with reference to existing and potential competitors. The potential investors also want to know if the invention or innovation offers a dramatic and sustained advantage, and whether there is compelling evidence to warrant building a business based on the invention or innovation. They seek to evaluate both the strength of an innovation and the ability of the entrepreneur to motivate commercialization.

Venture capitalists want to maximize returns and minimize risks. The risks they must consider in reference to the intellectual property include: market, financial, management and technological<sup>2</sup>. A new technology enterprise cannot normally afford litigation. It needs to devote its money, time and resources to technology development and commercialization. The threat of an expensive lawsuit may be sufficient to reduce the probability of venture capital financing. Patent lawsuits cost about \$500,000 per claim if brought to trial, and trade secret suits cost from \$300,000 to \$500,000<sup>3</sup>. Thus, intellectual property in the form of a trade secret may be more attractive to venture capital investors than a “weak” patent that may be open to litigation.

An example of the impact of intellectual property and its strengths is how companies that work with new enterprises value these properties. Catalyst Venture Partners<sup>4</sup> is a group that “works with companies to get them ready for external investment whether that investment is sourced from individuals or institutions.” Catalyst Venture Partners works only with enterprises “that have exceptional intellectual property and are in a position to achieve fast growth.”

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<sup>2</sup> See Henos (1993)

<sup>3</sup> See Silverman (1989)

<sup>4</sup> See Partners (2004)

## Modelling the Interaction

Without the strength of the intellectual property and its protection, little if any investments would be made into new or growing enterprises. Figure 1 is a model of the interaction of intellectual property and venture capital. This model shows that even at this simplified level a degree of complex interactions exist. However, with the lack of any of the elements shown in this model, serious constraints would be placed on this major economic driver.

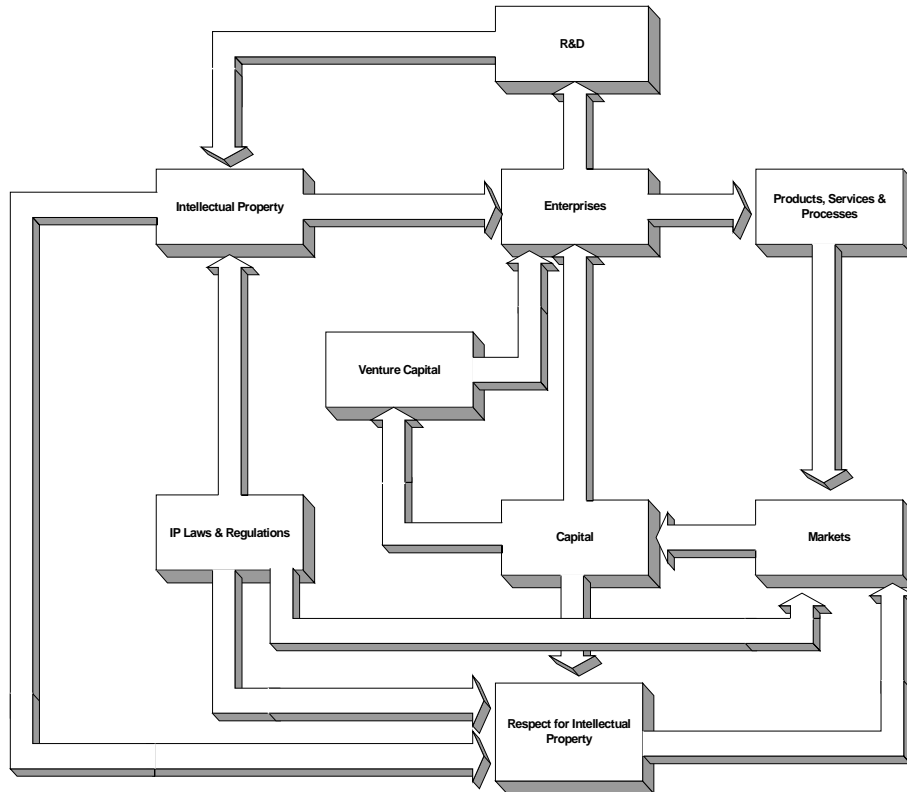


Fig. 1 Model of Interaction of Intellectual Property and Venture Capital

We should consider this model from four critical points:

1. Intellectual property stimulates more intellectual property,
2. Intellectual property which is indigenous leads to respect for all intellectual property,
3. Intellectual property stimulates and stabilizes markets, and
4. Intellectual property generates capital and is impacted by capital and, in turn, impacts the availability of venture capital.

As Figure 1 shows there is a feedback mechanism to the generation of additional intellectual property. This becomes evident if we look at the growth of patent

applications. It appears that economies, which develop intellectual property, stimulate the development of additional intellectual property.

### **The Importance of Intellectual Property Assets**

Exclusive rights offered by the intellectual property system are often the main assets from which an SME technology-based enterprise can benefit. The appropriate use of the intellectual property system may contribute to bring high rates of return on capital, which is crucial in order to attract venture capital investors to an SME<sup>5</sup>

The economic value of a patent, a trademark, software, a domain name, and any intellectual property must be carefully weighed in the analysis of which companies deserve to receive venture capital investments. Not all intangible assets are equal. The venture capitalist must use consistent techniques for valuating the intangible assets of the target enterprise and take decisions on when and whether to invest based on such valuation.

One of the most important issues evaluated by venture capitalists is the security of intellectual property. Normally, a strong patent position is desired and the issues of ownership of intellectual property need to be well understood, particularly where the inventor is doing the research at a university or other research institution. The venture capitalist must also consider all the potential costs associated with patents and their protection.

Various market mechanisms play a central role in technology diffusion. This causes the innovation process to become more competitive, cooperative, globalized and foster new technology based enterprises and industries. To accommodate these factors, enterprises require more and robust intellectual property to stay globally competitive. The Organization for Economic Co-operation and Development (OECD) has shown that positive changes in the legal and regulatory framework of patent regimes in United States, Europe and Japan have resulted in the growth of patentable subject matter and more robust and valuable patents<sup>6</sup>.

These market mechanisms coupled with changes in legal and regulatory regimes have led to an increase in patenting. Also, the ability of patent holders to protect their rights has also increased further fostering others to patent their own inventions. This positive feedback in the intellectual property system (See Figure 1) must be supported by other factors.

An important factor, which stimulates intellectual property development and in turn leads to additional availability of venture capital, is the respect for intellectual property rights in general, as this too leads to mitigation of risks.

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<sup>5</sup> Thompson (2002)

<sup>6</sup> OECD (2002)

Reinforcing and broadening the rights provided to holders of intellectual property have resulted in increasing their value to enterprises. This, in turn, has helped venture capitalists to see potential returns for their investments that in turn lead to more innovations and growth in markets.

Over the last decades patents have played an increasingly important role in innovation and economic performance.<sup>7</sup> This role of intellectual property has led not only to economic growth but also to the stabilization of markets. When investors see growing markets they then move to capture the economic rents that may be associated with the growth.

On an individual enterprise basis, as the companies receive economic benefits from their intellectual property they tend to reinvest a portion of their gains into research and development (R&D). This R&D leads to further innovations and thus helps enterprises when seeking additional capital for growth. All of these factors not only generate capital for enterprises enjoying the benefits of the intellectual property but to venture capital entering new markets.

According to a study by Lerner and Kortum, increases in venture capital activity in an industry market segment are associated with significantly higher patenting rates. The study further noted that from 1982 to 1992 the ratio of venture capital to R&D in the US averaged less than three percent while venture capital may have accounted for eight percent of industrial innovation in the same period<sup>8</sup>.

As Figure 1 illustrates, the linkage between venture capital and intellectual property may not be direct but it is an important element in the total system. A venture capital investor must consider a number of factors as related to intellectual property. These factors coupled with strong intellectual property systems lead to development of SMEs. Once the system starts the natural economic vector will lead to more intellectual property leading to further venture capital investments and respect for all intellectual property.

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<sup>7</sup> OECD (2004)

<sup>8</sup> Lerner (2000)

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