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Financing E-Commerce: Legal and Practical Risks

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Abstract

As the e-commerce sector continues its global expansion into the 21st century, an associated need for financing for e-businesses emerges. As has been the case to date, it appears likely that the main sources of finance will continue to be capital investors, and perhaps also traditional debt financiers such as banks and other financial institutions to some extent. Problems will increasingly arise because the asset bases of e-commerce vehicles mainly comprise rights in various computer systems and valuable commercial information. This can create significant problems in relation to accurate valuation of a business and its individual assets for finance purposes. This article surveys some of the legal and commercial issues surrounding the financing of e-business and, in particular, those associated with financing start-up ventures (often referred to as 'dot.coms').

Keywords: E-commerce, Finance, Intellectual Property, Collateral, Joint Venture, Security

1. Introduction : Finance for E-Commerce

The recent rapid rise of e-commerce has many implications for the global business community, not the least of which relate to effective financing. Increasingly, the key activities of many businesses revolve around effective use of information technology. In general, such businesses are involved in combining products, services and information with available technology to create an e-commerce vehicle that ultimately has a business or personal application somewhere in the global community.

Obviously the development, enhancement, licensing and / or use of computer software tends to be very important to most of these businesses. Additionally, the commercial information these businesses are able to generate and protect is often of great value to them. This can include information about customer bases, technological processes, business methods etc.

Depending on the type of business and its stage of development, financing can be problematic. In the case of a 'start up' businesses, for example, there may be few assets other than an existing or proposed software system and perhaps some valuable commercial information that can be offered to a debt financier as collateral for a loan and / or used in the valuation of the business for investment purposes.

Contrasted with a business that is a 'going concern', the latter will most likely exhibit some cash flow and / or commercial goodwill as an indicator of its objective market value. Apart from business valuation purposes, cash flow can also be quite useful in generating revenue in its own right.

Why the particular interest in financing e-commerce ventures? Markets have always adapted to the need for finance for new types of business enterprises. What is perhaps different now in this 'global information age' is the nature and extent of the enterprises concerned. In terms of debt financing, banks have never before been faced with such high

volumes of business being proposed by companies with such apparently amorphous asset bases. This, in turn, affects the type of collateral a bank can seek in support of a loan. It also clearly affects the ability to accurately value the business overall as a viable commercial enterprise both for loan finance purposes and in relation to the possibility of equity (investment-based) finance.

Asking investors to take a gamble on an e-commerce venture sounds all well and good, particularly in the age of information technology, but many small investors recently saw how amorphous an investment in a '.com' venture can be. Certainly, a number of people were stating the 'golden rule of .com investment' recently as being to invest in companies with known and tested products. This begs the question of how an e-commerce business can move from being a 'new player' to a 'company with a known and tested product' if it cannot receive start-up finance in the first place. Perhaps existing 'bricks and mortar' enterprises that establish an e-commerce business as a sideline to their main business could have an advantage here, although this is open to debate.

In terms of 'start up financing', larger investors may be interested in some kind of 'joint venture' arrangement with the proponent of a new e-commerce idea. Such investors may be prepared to shoulder significant amounts of risk, but for their trouble they may require a particularly large slice of the pie in terms of equity.

It seems clear that new e-commerce ventures will continue to develop and to thrive. As e-commerce entities develop strategies for approaching such lenders and investors and convincing them to part with funds in favour of the business, banks and independent investors will simultaneously develop rules of thumb for evaluating risks and protecting their interests. This paper will attempt to bring together some of the issues with which banks and potential investors might be faced in deciding whether to invest money in (including lending money to) an e-commerce venture, notably those in the 'start up' category.

2.The First Question: Equity vs Debt Finance

Initial questions for directors of an e-commerce business revolve around what type of finance the business will require and at what stage of its development it will need to seek finance. The likely costs of finance will be of particular concern, as with any business, both in terms of actual financial costs and the possible need to forego equity in the overall business in favour of a finance partner, as with joint venture financing.

E-commerce businesses often seek investment (or equity) financing which may be easier to achieve than debt financing for reasons discussed below. However, trends in a market will influence the availability of such finance. As noted above, investors are possibly somewhat more cynical about a lot of '.com' businesses than they were 12 to 18 months ago. On the other hand, established e-commerce businesses with a solid reputation in a market may have more luck. There is the associated possibility of joint venture financing, as contemplated above. This is another form of equity financing where the business in question takes on one or more equity partners who provide up-front capital either from their own resources or on behalf of a syndicate of other investors.

There is the alternative of seeking debt finance from a bank or other financial institution. However, banks have not been particularly comfortable lending to e-commerce businesses to date. Their most significant concerns in this respect have included problems with evaluating what the borrower is worth as a going concern, and what its individual assets might be worth with the possibility of a default sale in mind. The latter of these issues raises additional concerns relating to the rather technical and difficult area of intellectual property in computer software and associated rights, including rights in commercial information. These are issues with which banks have not traditionally dealt on a day to day basis in times past.

It may, of course, be possible for the business in question to combine certain levels of equity finance with some debt finance so the risk of business failure is shared between the different classes of investors. A number of the fundamental legal and practical concerns will remain basically the same even where the balance between equity and debt financing varies.

The following discussion identifies some of these issues and discusses them with reference to both equity and debt financing, concluding with some specific comment about the position of debt financiers. This is because traditional debt financiers such as banks have long-established methods for granting loan finance often including detailed standard form loan and mortgage documentation. It is becoming increasingly obvious that these standard methods are ill-suited to e-commerce ventures. This necessitates banks and their lawyers fundamentally re-thinking their strategies for the provision of loan finance in this context. An associated question is whether debt finance is at all viable for these types of businesses in the final analysis, at least from a bank's point of view.

3. Financing E-Commerce: Some of the Risks

3.1 Identification and Valuation of Assets

As noted above, clearly two of the central issues for anyone considering funding a software-related business are:

(a) valuation of the *business as a whole* as a going concern, including any goodwill it may have generated; and,

(a) identification / valuation of *specific business assets* that might be sold to third parties to recoup lending losses.

With respect to the (a), there is an increasing literature, largely coming out of international accountancy firms, relating to methods for valuation of a business whose main asset base consists of various types of information and information technology. This literature also has some application to the valuation of individual items of intellectual property such as copyright in a particular iteration of a computer program.

Item (b) above breaks down into two components involving:

(i) identification; and

(ii) valuation of particular assets.

As noted above, methods for valuation of relevant assets have started developing in recent times. However, there are some particular risks involved in valuing information technology products (and valuable information *per se*), including the fact that these assets sometimes only prosper in the hands of their developers. This can lead to concerns that they are of limited use as loan collateral in a debt financing scenario as they may have no objective market value in a default sale situation.

What is perhaps an even more significant question, notably from a legal perspective, is the **identification** of the relevant assets - and here the term 'assets' must be distinguished from the legal concept of 'property'. The former is a broader accountancy term that tends to be used in business as describing something said to have a notional value that can be attributed to it on a balance sheet. It will include valuable intangibles that have a proprietary nature such as the various forms of intellectual property rights - copyright, patents, trade marks etc. It will also include things that the law has had more trouble categorising as property. Obvious examples are commercial goodwill, valuable information and, more recently, some 'information age intangibles' such as Internet domain names and meta-tags.

The fact that not all assets capable of having distinct value attributed to them are clearly regarded as property at law may well be more significant in debt financing than equity financing. This is because a bank lending money to a business will generally require the business to put up some form of loan collateral in support of the finance. This will often comprise individual assets to which the bank may have recourse on default under the loan. Such recourse should include the possibility of on-selling the particular asset(s) in question in the event of default in order for the bank to recoup its losses under the loan.

Where an item does not comprise legal 'property', this could make on-selling it difficult as a matter of law and commercial practice. The lack of legal proprietary status of an item will not always mean that a default sale is impossible, but it may have to take a different form than a traditional sale of more standard tangible plant or equipment. It may also raise legal concerns not usually present in a default sale scenario with more 'typical' assets such as plant, equipment or stock-in-trade.

For example, an attempt to sell an Internet domain name on default will not really amount to a sale of property as traditionally contemplated at law. It will actually involve the de-registration of the name with the registering authority (eg Network Solutions) and the re-registration of the name to a new entity nominated by the bank, if an interested 'buyer' can indeed be found in the market for that particular domain name.

This is not a problem where the registering authority is sympathetic to such transactions

and provides assistance with them in a way that likens the transaction to a standard sale of property. This has certainly been the position adopted by Network Solutions in the United States in respect of '.com', '.net' and '.org' names. It may be a problem with some smaller registries in other jurisdictions if there are no established procedures for ensuring that a third party cannot register a name in between the de-registration of the original owner and the proposed re-registration to the financier's nominee. There may also be trade mark law complications that need to be considered to ensure that the sale of the name to and use by the new entity will not contravene any existing registered trade marks, notably any such marks held by the original borrower.

Of course, there will always be the associated 'valuation' issue with items like Internet domain names. Will there be an interested 'purchaser' for a given domain name, particularly if it has not been used successfully in the past and has no commercial goodwill associated with it? The same concerns will arise with items such as trade secrets, computer software copyright etc.

Additional novel legal and practical issues will arise in the case of default sales of other e-commerce assets. One Australian commentator has emphasised the importance of financiers with security interests in computer software copyright also taking security over (or otherwise gaining access to) any physical media in which the software is stored, such as computer disks or CD-ROMS. Otherwise, the financier cannot effectively access its loan collateral in order to sell it on default.

3.2 Commercial 'Shelf Life' of E-Commerce Assets

As noted above, the asset base of an e-commerce venture is often comprised mainly of intangibles that have only short term value in and of itself. It is their use and development that have the potential to enhance the ultimate value of an e-commerce venture. If the main assets of a business are information and software that comprise little value *per se*, what comfort is there for the financiers who want some concrete assets that they might sell on default?

Potential investors, too, may have difficulty seeing how particular assets of the business will be used to generate sufficient revenue to make the business a worthwhile investment vehicle in the long term. This may be a more relevant concern for a joint venture capitalist than for a market investor who can always sell shares while the business is still doing well financially. However, even the smaller market investor takes the risk that potential purchasers of the relevant stock will not be convinced that the business will continue (or indeed begin) to thrive. This may impact negatively on the price the investor can obtain for the stock. These questions are obviously closely related to the confidence of the potential investors in the ability of the directors of the relevant e-business to use their ideas and assets effectively to generate and /or enhance the business' value.

In terms of specific asset valuation, it is important to realise that some 'information age intangibles' have a commercial 'shelf life' that is considerably shorter than their legal life. It may be small comfort that the business in question asserts copyright in particular software, or even secures a patent over that software or other technological process in the

long term. Although the laws in most jurisdictions protect certain defined property rights in such items often over substantial periods of time, the commercial value may be long gone well before the relevant intellectual property right(s) expire(s) at law. For example, computer software copyright may well last for over 70 years, but the commercial value of the software might dissipate after two or three years at best. This will be relevant to financiers considering a potential default sale situation. It will also be relevant to equity investors in terms of their confidence that the business in question has the ability to continue to develop and improve its software.

3.3 Ease of Copying Software and Independent Reinvention

Another issue that ultimately relates back to the value of the assets of a business is the ease with which software products in particular can be copied by competitors sometimes without necessarily breaching applicable intellectual property laws. This can obviously impact negatively on the value of the original software in the hands of the business seeking finance. The impact will be felt by any financiers if copies of software are successfully marketed by a competitor of the financed entity after the provision of finance, thereby cutting into its revenue stream. Obviously, there will be a major problem in such cases where the financed entity cannot establish a breach of copyright and seek recompense for it. However, even where it is in a position to sue for damages for breach of copyright, this is often a costly and time consuming process that can have major financial implications for the business and its financiers.

Software copyright cases have been notoriously difficult to litigate, particularly in terms of the evidence required to establish both copyright ownership in the software in question, and breach of that copyright by the defendant. This has been partly due to the legal profession's unfamiliarity with the information technology industry and its products and processes, and partly to do with having copyright laws which have not been tailored effectively to protect works in the information technology area.

A number of jurisdictions, including Australia and the European Union, have spent some time revisiting existing copyright legislation to ensure that unfair copying of software cannot circumvent the copyright legislation. However, this may not fully counteract the practical problems, particularly bearing in mind the cost of suing for breach of copyright, as noted above, as well as the limitations of national copyright systems in an increasingly global trading environment. Additionally, copyright law does not protect an original software developer against independent reinvention which is quite commonplace in the software industry. It only protects against substantive copying of the original software.

Securing a patent, on the other hand, will protect the holder against independent reinvention to some extent. However, the relevance of patent law to the computer software industry is questionable with a number of governments taking a policy view that patent protection is not appropriate for computer software.

Further, commercial issues of enforcement cost would arise in relation to software-related patents similar to those that arise in relation to software copyright. Given the ambivalence of patent law in respect of software-related inventions, there is also perhaps a greater risk

that the result of litigation could be a successful challenge to the initial validity of a patent.

With patents there is also the concern that a competitor may 'design around' the specifications of a patent and thus market a very similar product without technically breaching the original patent. This naturally impacts on the value of the software patent to the original developing entity with obvious flow-on effects to its financiers.

Finally, there are significant costs associated with patenting a software-related invention, even assuming the hurdle requirement of patentability within a given jurisdiction. Costs may be particularly troublesome in situations where it is necessary to patent an invention in multiple jurisdictions to ensure effective legal protection, an unfortunate result of maintaining national intellectual property registration systems in an increasingly global marketplace.

3.4 Particular Risks for the Debt Financier

Banks considering lending money to businesses against software-related items and valuable information as collateral should also be wary of certain additional problems. It may be that these are more pronounced in an Anglo-Australian common law system than in a system operating a secured finance law based on Article 9 of the United States' Uniform Commercial Code. Some of the north American legislation has attempted to deal more specifically with 'information age' issues in financing and notably financing against valuable intangibles. Article 9 has recently been revised partly with these aims in mind. Moves are also underway in Canada to investigate the need for reform of secured finance law to accommodate security interests in various forms of intellectual property.

The main problems for banks in this context will revolve around their ability to identify and effectively take security over items that sometimes have equivocal proprietary status at law. Again, this is arguably a more pronounced problem in an Anglo-Australian system where secured finance structures tend to be legal and equitable mortgages and equitable charges. These structures focus on dealing in proprietary interests in particular items which is difficult to do if the item in question does not have an unequivocal legal status as property. Again, some obvious examples would be valuable commercial information, Internet domain names and unregistered names and marks.

One advantage of Anglo-Australian finance law is that it has the concept of a 'floating charge' which hovers over assets of a company as they circulate in and out of the company's hands on a day to day trading basis. The charge can then 'fix' on all the assets in the borrower's hands in the event of a default under the loan. It will also arguably capture valuable commercial information which cannot otherwise be harnessed under a fixed mortgage or charge due to the fact that it is not regarded as 'property' at law. However, the floating charge structure does not create a 'fixed' security over a particular asset from the outset if that is indeed what the lender requires.

Clearly it is possible for a financier to obtain a fixed mortgage or charge over a particular item if that item can be described as some form of legal or equitable property. With

software, that will usually involve identifying copyright or a patent in the software as these intellectual property rights are, by definition, regarded by the law as property. However simply stating that a charge or mortgage is to be fixed over 'the computer software of the borrower' is not conclusive if the bank has not satisfied itself that the borrower has a copyright, patent or at least a licence to use a copyright or patent in the software in question.

Even where the bank is satisfied that the borrower has a legally recognised intellectual property right in a software-related product, the intellectual property legislation itself can create problems for the lender. Lenders should be aware of provisions in intellectual property statutes relating to assignment and registration of interests in intellectual property rights as well as to priority of legal and equitable interests in such rights in the event that a dispute arises. They should also check whether relevant legislation includes specific provisions dealing with licences of intellectual property rights, particularly when dealing with computer software. These could affect the lender's ability to deal in secured intellectual property on default if appropriate protections have not been included in the security documentation.

Additionally, lenders should, as a matter of commercial practice, conduct due diligence exercises to ascertain whether any licences or other interests have been granted in relation to intellectual property in the relevant software. This should include an investigation of what any such rights entail in practice and how they might affect the value and transferability of the borrower's rights in the software in the event of a default sale.

Registration of security interests is also important for debt financiers and can be quite complex and costly in certain jurisdictions. Australia is a good example with its mixture of federal and state based registration systems for various proprietary interests in different forms of intellectual property. There is also some resulting confusion over which registration / priority system takes precedence in the event of a conflict. Some intellectual property rights also exist in which specific security interests, as opposed to general interests under floating charges, are unregistrable in certain jurisdictions.

Where registration is possible it may prove costly and time consuming, particularly where multiple registrations are required within a jurisdiction or between jurisdictions. The latter issue is again the result of maintaining national intellectual property and secured finance laws in an increasingly globalised trading environment.

Notwithstanding the confusion, registration can be very important to ensure priority to the asset in question on default. However, it can be costly, particularly where multiple registration within a jurisdiction is required. It can be even more costly when registration in a number of different jurisdictions is required as, for instance, to protect a security interest in computer software copyright in a number of jurisdictions in respect of the same debtor. This is again a function of having national intellectual property and secured finance systems in a global economy.

4. Concluding Comments

All of the inherent difficulties related to financing e-commerce businesses have the potential to increase the cost of obtaining finance and / or the difficulties associated with arranging suitable avenues of finance. This could have serious negative impacts on many such businesses, notably at the 'start up' stage. Whether this 'chilling effect' does or does not become more apparent in coming years remains to be seen.

However, it is certainly a risk that some good business ideas will not come to fruition unless the proponents happen to win the lottery. Clearly the flipside of this particular coin is the question as to why investors and banks should be prepared to take on such potentially significant risks. This is ultimately a question of portfolio management for each potential financier.

There may well be significant commercial rewards resulting from wise investment / support of particular e-businesses. The trick will be for debt and equity financiers alike to develop means of predicting with some accuracy where and how best to invest. Banks and financial institutions who have traditionally engaged predominantly in debt financing may also begin to consider the possibility of increasing involvement in equity financing as a joint venture participant. This could be done either with their own funds or as a coordinating entity for the funds of other investors, depending on a bank's willingness to engage in such activities.

Perhaps there is an argument that traditional debt financiers should investigate in more detail some of the potential financial rewards of both equity and debt financing of e-commerce. This is because their traditional debt financing customer base may well become eroded commensurate with the rise in e-businesses in similar fields of endeavour. Obvious examples would be retail businesses dealing in products such as books, music, clothing etc. If it is cheaper and easier to buy some of these products online, it would be reasonable to expect a downturn in 'bricks and mortar' businesses engaging in the same areas of retailing practice. This, in turn, will impact on the nature and type of businesses with which banks and financial institutions can deal in terms of financing.

Clearly the development of Internet trading and e-commerce generally is having a profound effect on ways in which business can be done on both a local and a global scale. One might argue that it would be a shame if the full potential of e-commerce is never explored due to the inability of new players to obtain necessary levels of finance. However, this must obviously be balanced against the need to develop effective financing strategies from the point of view of potential investors and lenders. It will be interesting to see how the global market develops in this respect in coming years.