Clearing the hurdles for IP securitisation in the US

The ability to securitise IP can be a valuable tool for companies looking to raise finance. For any deal to go through, however, a series of important legal issues must dealt with

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What do the latest best-selling novel, your favourite brand of soap, the current chart-topping song and the latest pharmaceutical pain reliever all have in common? The value of each resides to a greater or lesser extent in intellectual property. This is readily apparent to most consumers, who would quickly agree that they are paying for the story or the song, not the book's paper and binding or a shiny compact disc. And even though the average consumer might insist that it's the quality of his or her soap that matters rather than the brand name, it is undeniable that there is substantial value in brand loyalty earned through a history of product quality or assiduously cultivated through advertising. However, intellectual property, despite its ubiquity and substantial value, remains a relatively undeveloped asset class in the world of securitisation, and continues to constitute a vast reservoir of financing potential for its owners.

Although not all intellectual property is of a form that enjoys governmentally sanctioned exclusivity and federal registration offices, most intellectual property assets consist of patents, copyrights and trademarks which – the US at least - enjoy both. While each is very conceptually distinct, each entitles the owner thereof to certain rights and privileges accruing from commercialisation. Just taking as an example a compact disc or CD, the revenue realised by a record company on the sale of single CD (which CD will bear the trademarked logo of the record company) will generate payments owing to Phillips Electronics and Sony, each of which owns significant patents for compact disc recording technology, and the publishing company that owns the copyrights to the recorded songs. And although the Rolling Stones insisted "it's the singer, not the song", it is really both – both the songwriter and performer are entitled to royalties from the revenues on the sale of a CD.

Sporadic success

Although patents, copyrights, trademarks and performance rights have all been the subject of securitisations, each such asset category continues to be a sporadic presence in the deal sheets. Various factors account for the failure of IP to live up to its potential to date as an asset class for the securitisation market. One factor is the relative complexity of such assets as compared to receivables assets and other financial assets. Another factor is the lack of awareness of some of the holders of these assets of the benefits of securitisation. A third factor is that the holders of large pools of these assets have access to alternative sources of financing which are more favourable than or as favourable as securitisation. A fourth factor is the disappointing results of some early copyright, patent and trademark royalty transactions, which have been well publicised.

In 1997, Bowie Bonds were issued by a trust that had acquired certain copyrights and performance rights from the eponymous David Bowie. The first securitisation of performance royalties ran into difficulties when lower than projected royalty streams resulted in the downgrading of the bonds, which by last year had been downgraded by Moody's Investors Service to one grade above junk bonds. Although the Bowie Bonds were quickly followed by a series of transactions backed by publishing, copyright and performance rights of various notable acts (including a number of Motown artists), there have been few issues since 2001.

In June 2000 Royalty Pharma securitised Yale University's patent for Zerit, an HIV drug licensed by Yale to Bristol-Myers Squibb. Standard & Poor's rated the transaction A on the basis of projections of Zerit sales and Yale's and Bristol-Myers Squibb's credit ratings. BioPharma Royalty Trust issued US$115 million in debt and equity securities. Yale University realised US$100 million from the transaction. However, lower than projected cash flows generated by Zerit caused the transaction to violate certain financial covenants for three consecutive reporting periods, thereby causing the transaction to enter into early amortisation in November 2000.

Trademark securitisation also had an unfortunate early experience, but for reasons quite different from the patent and copyright/performance rights transactions. Although the US$155 million securitisation of the trademark franchise assets of motel franchisor Days Inn was performing adequately, its sponsor was not, and Days Inn declared bankruptcy. Days Inn, as debtor, caused the bankruptcy remote special purpose vehicle (SPV) that had issued the securities to file a petition in bankruptcy, and prevailed upon the bankruptcy court to substantively consolidate the assets of the bankruptcy remote SPV with the assets of the bankrupt Days Inn, under a core assets analysis (ie, an analysis that found the trademarks to be core assets of the bankrupt debtor). The bankruptcy filing by the SPV caused the securitisation transaction to default notwithstanding the compliance by the asset pool's performance and cash flow with the transaction covenants.

While development of the securitisation markets for these asset categories may have been deterred by initial disappointments, the capital markets cannot long forget a pool of assets as lush as intellectual property. The total worldwide asset value of patents alone has been estimated to be over US$1 trillion. However, many of these patents are held by large technology, manufacturing, pharmaceutical and consumer products companies. Notwithstanding the ostensible benefits of increased liquidity, off-balance sheet, non-recourse financing and debt-for-tax treatment, and the retention of control over the intellectual property and the right to receive residual cash flows after debt service, there are various reasons why large companies with substantial intellectual property assets and top tier credit ratings might conclude that securitisation is of marginal benefit. As noted by Ira Wagner in *Intellectual Asset Management*, September 2003, Issue 2, many large pharmaceutical companies have credit ratings sufficient to permit them to borrow on terms as advantageous as they would obtain by securitising their intellectual property assets. At the other end of the spectrum, smaller companies, although possessing valuable intellectual property, may not have enough assets for a transaction sufficiently large to justify the fixed costs of structuring the transaction and obtaining a rating.

Although not subject to the same incentives to securitise intellectual property assets as less well-heeled competitors, larger companies have, with help from the consulting industry, begun exploring and formulating commercialisation and monetisation strategies for their intellectual property assets. Whether such strategies will culminate in securitisation is unclear, but the financing and joint venturing transactions are frequently intermediate steps towards securitisation. In its most basic form, this strategy can take the form of a sale of the IP assets. In May 2005, Fortress Investment Group LLC, an investment fund that manages some US$15 billion, acquired from Bank of America Corp, took on US$270 million in loans secured substantially by Michael Jackson's 50% interest in the publishing rights to the Beatles' song catalogue. Fortress, as an investment fund with a shorter investment horizon and higher target rate of return than Bank of America, may be a more likely candidate to securitise the assets.

For smaller companies, financial institutions and investment funds have been acting as intermediaries in the capital markets financing of intellectual property. Both Paul Royalty Fund and Royalty Pharma have acquired interests in revenues generated by various owners of patented healthcare products (primarily pharmaceutical products) and have securitised diversified pools of such assets. By aggregating assets from numerous patent holders and assembling a diversified pool of assets, Paul Royalty Fund and Royalty Pharma were able to achieve economies of scale and diversification unavailable to the patent holders.

Steady deal growth

The willingness of larger companies to explore commercialisation and monetisation strategies for their intellectual property assets, and the ability of smaller companies to transact with investment funds and other financial intermediaries that view securitisation as an essential element in the financing of their IP asset acquisitions, portend a steady, if measured, migration of IP assets to the securitisation markets. Having arrived there, the sponsors of these IP securitisation transactions and their financial and legal advisers will encounter a level of scrutiny of the securitised assets by rating agencies that far exceeds that generally associated with more conventional asset categories. As noted by a director at one of the rating agencies that rated a Royalty Pharma securitisation: "These assets are not mortgages, they're not credit cards. They are very specific, unique assets."

The uniqueness of IP assets is largely attributable to two factors. First, the assets are quite literally unique or *sui generis*, lacking the relative uniformity of transaction terms and documentation that has been developed in the mortgage and consumer finance industries. Each licence of patent technology or a copyright or other IP asset is in effect a one-off transaction between the licensor and licensee. Second, licences of intellectual property assets and the related royalty cash flows are analysed as future flow transactions, or transactions in which the royalties or other payment obligations are, unlike the fixed nature of the payment obligations under mortgages or consumer receivables, contingent upon sales of the related product or other measures of the commercialisation of the IP assets.

In the case of licensing of patents, one of the more complex IP asset categories, the licensing transactions generally involve executory contracts which may be rejected by a bankrupt debtor under Section 365 of the US Bankruptcy Code. Executory contracts are contracts under which substantial obligations remain to be performed on both sides. Patent and copyright licences are usually considered executory contracts because both licensor and licensee have ongoing obligations after entry into the contract: the licensor, to provide use of the patent or copyright to the licensee (and frequently, in the case of patents, obligations to provide technological support to the licensee and to defend the patents against infringement), and the licensee, to make royalty payments. Section 365(n) provides that upon rejection of a licence contract by a bankrupt licensor the licensee may elect to retain its rights under the licence to exploit the copyright or patent commercially, provided that the licensee continues to perform its contractual obligations under the licensing contract.

Rating a deal

Consequently, the rating agencies rating a securitisation of IP licences will require a legal analysis of the consequences for the transaction of: (1) a bankruptcy of the licensor/securitisation sponsor; (2) a bankruptcy of the licensee; and (3) in the case of IP licensed to the securitisation sponsor, which licensed IP is necessary or materially beneficial to the commercialisation of the securitisation sponsor's own IP, an analysis of the bankruptcy of the licensor of IP to the securitisation sponsor.

Bankruptcy of IP licensor/securitisation sponsor

The bankruptcy of any licensor of intellectual property, which intellectual property relates to a royalty or other cash flow interest that has been securitised, would permit the licensee to invoke Section 365(n) of the Bankruptcy Code and thereby retain the licensed rights to the intellectual property (subject to certain limitations contained in Section 365(n)). However, Section 365(n) protects only the licensee's rights in the patent or copyright, not ancillary contractual obligations of the licensor to provide technological support or other services. Accordingly, a bankrupt licensor could reject provisions in the licensing contract that require the licensor to perform functions in support of the licensed intellectual property. The assumption, or assumption and assignment, of the support functions would require that the licensor continue to perform the support functions or designate an assignee that could provide comparable support functions. Any default by a licensor in providing support functions following assumption thereof would give the licensee an administrative priority with respect to damage claims relating to such default.

Bankruptcy of licensee

The bankruptcy of a licensee of intellectual property from the licensor/securitisation sponsor, such as a distributor or manufacturer of a commercial application, will generally permit the bankrupt licensee to reject or assume the licence contract. A rejection of the licence contract would permit the licensor to seek to relicense the intellectual property to another licensee, as well as pursue any claims against the bankrupt licensee arising from pre-bankruptcy defaults. The assumption, or assumption and assignment, of the licence contract would require that the licensee continue to perform its obligations under the licence contract or designate an assignee that could provide comparably. Any default by a licensee in performing obligations under the licence contract following assumption thereof would give the licensor/securitisation sponsor an administrative priority with respect to damage claims relating to such post-assumption default.

Bankruptcy of a licensor of IP to the securitisation sponsor

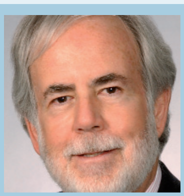
Owners of IP assets frequently must license from others related IP necessary or extremely beneficial to commercialisation of the securitisation sponsor's own IP. The bankruptcy of a licensor of IP to a securitiser of IP assets will generally trigger the executory contract analysis set forth above under *bankruptcy of IP licensor/securitisation sponsor*. Accordingly, the licensor of IP to the securitisation sponsor may, in the event of such licensor's bankruptcy, either assume or reject the licence agreement and, if assumed, the licensee securitisation sponsor must continue to perform its obligations under the contract in order to retain the benefit of the licence. If the licensor to the securitisation sponsor rejects the licence agreement, the licensee/securitisation sponsor can invoke Section 365(n) of the Bankruptcy Code and thereby retain its licensed rights to the IP under the licence contract (including the right to enforce any exclusivity provision in the licence contract). However, any obligations of the licensor to provide ancillary services may be rejected by the bankrupt licensor.

Incentives to reject or assume

The licensor/securitisation sponsor will generally have the incentive to assume an agreement pursuant to which it has licensed intellectual property to a third party. The consideration payable under IP licensing contracts generally consists primarily of payments related to the licence of the intellectual property, as opposed to ancillary services provided by the licensor under the contract. Accordingly, a bankrupt licensor will prefer to continue receiving the royalties and other consideration payable in respect of the licence unless confronted with a substantial failure to perform by the licensee. If continued performance of ancillary services by the bankrupt licensor is burdensome to the licensor, but the licensor wishes to ensure the continued delivery of such ancillary services to the licensee, the bankrupt licensor will generally seek to assume and then assign the licence contract to a third party. There may be circumstances under which a licensor would have an incentive to reject an exclusive licence of intellectual property to a licensee if the licensor could obtain better licensing terms from a third party. However, an exclusive licensee could invoke Section 365(n) of the bankruptcy code to block any such rejection of the basic licence.

A bankrupt licensor of intellectual property to a licensee/securitisation sponsor, or a bankrupt licensee of intellectual property from a licensor/securitisation sponsor, will similarly have an incentive to assume the licence contract so long as the securitisation sponsor is continuing to perform its obligations under the licence contract. There may, however, be unusual circumstances under which a bankrupt licensor has an incentive to reject an exclusive licence to a licensee/securitisation sponsor if it can obtain better terms from a third-party. However, even under that circumstance the licensee would have the option of agreeing to renegotiate the terms of the licence agreement to accommodate the licensor's demands.

In each case outlined above, the bankruptcy risk of a securitised IP licence that the rating agencies must analyse is the risk that a party to the licence contract which is disappointed with the commercial transaction will avail itself of the opportunity in bankruptcy to reject the contract, if such disappointed party is the bankrupt licensor; or, in the case of a disappointed licensee, the risk the licensee will not avail itself of its Section 365(n) right to retain the licence of IP rights and continue making royalty payments to the bankrupt licensor. In assessing the likelihood of these potential terminations of securitised IP licences, the rating agencies apply a reasonable business judgement test from the perspective of the licensors and licensees. An analysis of the ongoing benefits of the licence contract to the licensor, the investment of the licensees in the commercial exploitation of the IP licences and the prospects for successful commercial applications by the licensees will permit the rating agencies to assess the risk that an asset in the securitised pool would prematurely terminate as a consequence of the bankruptcy of one of the parties.



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