

# Using IPR To Raise Debt Capital

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Technique has advantages, disadvantages, whether it is widely employed remains to be seen.

**A** conclusion from a recent report by Arthur Andersen and the Intellectual Property Institute was that the opportunities for debt finance supported by the value of intellectual property (IP), if not necessarily secured upon it, will expand.<sup>1</sup> The challenge is therefore present for prospective lenders and borrowers to take up these opportunities. However, the use of IPR as the principal security for debt finance is still quite rare.

One of the more interesting developments in the area has been a growing interest in the securitization of IPR. This finance raising technique has hit the headlines on at least two occasions in the last couple of years. First, in 1997, when bonds worth around 1,000 million were issued. They were backed by a portfolio of copyrights and future equity payments on David Bowie's music. The second occasion was in 1998, when it was reported that Formula One was planning to raise about 1,800 million backed by broadcasting and media rights. The purpose behind this article is therefore to give a summary of some of the main aspects of IPR securitization.

## BASIC STRUCTURE OF AN IPR SECURITIZATION

Securitization is a method by which debt capital is raised from a portfolio of income-producing assets. Essentially, these assets are packaged together and then used to

raise loan finance. The income produced by the assets and any proceeds derived from their disposal or exploitation is then used to pay off both the principal and interest of the loan.

A major difference between using IPR to raise debt finance through conventional means and using IPR to raise debt finance by securitization is that, in a securitization, negotiable instruments, such as bonds, can be issued to investors who provide the funds. Consequently, there is often no need to seek funds purely from institutional lenders, such as banks. Investors can be sought from international capital markets to which the IPR owner may not otherwise have had access and whom, even allowing for the costs of writing up the securitization issue, the funds may be raised more cheaply. In addition, following a securitization the IPR owner will often be insulated from at least some, if not all, of the risk that the IPR will under-perform in the future.

In a typical securitization structure, the IPR owner (the originator) sells the IPR to be securitized to a special purpose vehicle (SPV), which is usually a specifically formed shell company with no employees, assets or liabilities other than those contemplated for the purposes of the securitization. The SPV raises the money to buy the IPR by issuing either publicly or privately, debt securities such as bonds to investors. These securities are usually assigned a credit rating by a rating agency and may be issued on a fixed or floating rate basis.

At the same time, the SPV will also create charges over the assets in favor of a security trustee for the benefit of the investors, the originator and any providers of credit

enhancement (see below). The SPV usually has no corporate connection to the originator, although the originator may be retained to act as agent for the SPV in order to administer or service the IPR and manage licenses.

## TYPES OF IPR SUITABLE FOR SECURITIZATION

A portfolio of assets suitable for securitization should be identifiable, stable, relatively homogeneous and capable of being assigned or charged. In principle, most types of IPR, including copyrights, trademarks, designs and patents, and cash flows arising from licensing this IPR, can fulfill these criteria.

Know-how and goodwill, by themselves, are probably less suitable for securitization. They can be difficult to define and in any event, without an associated patent application, the loss of secrecy in know-how tends to be catastrophic as to its value. On the other hand, goodwill is usually intimately associated with the underlying business or trademarks.

In addition, the IPR should obviously have a lifetime that lasts longer than the term of the debt securities, be resistant to challenge and produce predictable cash flows. From this point of view, copyrights and established trademarks tend to be much more suitable for securitization purposes than patents. Both of these types of IPR have a much longer lifetime than patents, which last at most 20 years and often prove their value only after some of this time has been used to commercialize and establish the relevant technology. In addition, patents are

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1 Mark Simon and Richard Post, "The use of intellectual property as security for debt finance," *Global Aspects for Intellectual Property Investors* (1998).

generally considered to be much more susceptible to attack than copyrights and well-established trademarks.

In a typical securitization, the present of principal and interest of the debt securities can, for the most part, only be supported by the cash flows derived from the portfolio of assets that are the subject of the securitization. Generally, therefore, the most suitable IPK will, for the lifetime of the debt securities, produce cash flows from a small number of licensees or other third parties that have credit ratings at least equal to the rating assigned to the debt securities or a large number of licensees or other third parties whose reliability can be estimated by statistical analysis and historical performance data. Realistically, such data often must cover a period of five years or more.

Taking the above into account, in patents, copyrights and associated film, music and broadcasting rights has constituted the main IPK to have been securitized so far (see table). However, there is no inherent reason why securitization should be limited just to this type of IPK. Indeed, securitization of license and franchise revenue has already been a feasible proposition in some businesses with strong brand names (such as Calvin Klein in table below).

In addition, a portfolio of patented technology should be more suitable for securitization than technology based on a single patent or concept. As an example, it was reported recently that a major pharmaceutical company was considering the issue of bonds based on the projected revenue from members of its products that were undergoing clinical trials. The cash tied by the bonds would have been used to fund up to US\$1 billion of its research and development costs.

#### ACHIEVING A HIGH CREDIT RATING

In practice, it is usual to obtain a credit rating for the debt securities in order to widen the potential investor base and reassure potential investors who may not be familiar

with the use of IPK as a securitized asset. A high credit rating is usually achieved by segregating, as much as possible, the IPK from the originator's business by ensuring that the assets are of sufficiently high quality, and by credit enhancement techniques.

Segregation of IPK from the originator can be difficult, since often the originator has built up particular expertise and goodwill in exploiting the IPK. However, complete segregation is generally desirable since then the IPK will be entirely isolated from any credit risks associated with the originator.

It follows that the best IPK for securitization is IPK that is mature enough to be exploited without participation from the originator. Since this is often difficult to achieve in practice, if the originator is retained to service the IPK, suitable arrangements should be built into the arrangements to ensure that the originator adequately manages and exploits the IPK for the term of the debt. In addition, it may be possible in the contract to appoint an industry expert to act as a substitute for the originator, if necessary.

The quality of the assets depends on the strength, predictability and reliability of the cash flow produced by those assets. In turn, these depend on the credit ratings of licensees or other third parties who will produce the expected cash flow and historical performance data. This can be a major hurdle to overcome and, again, means that established and mature IPK that has been generating a steady or increasing flow of income for some time is more suitable for securitization than IPK that has not yet proven its worth.

Finally, because of the underlying uncertainties inherent in any prediction of the future, some form of credit enhancement is usually arranged to reduce the perceived risk of default by the SPV. Indeed, a respectable credit rating may be impossible to achieve without such enhancement. This can take a variety of forms.

One technique is to over-collateralize the debt — in other words, for the SPV to raise an amount of debt that is less than the

estimated value of the assets. Other techniques include the use of guarantees, insurance, and senior and subordinated debt structures.

#### THE BENEFITS AND DRAWBACKS OF SECURITIZATION

There are several potential advantages to securitizing IPK. The SPV is likely to have lower liabilities and to have a lower perceived investment risk than the originator, thus the cost of funds may be cheaper. As stated above, securitization also offers an opportunity to tap into a more diverse range of funding sources and effectively shifts at least some of the risk of under-performance by the IPK from the originator to the investors and credit enhancers.

In addition, securitization may enable off-balance treatment for the securitized IPK, which may be desirable to the originator for regulatory, tax or accounting reasons. Finally, cash is released by securitization of the IPK. This increases the originator's liquidity and can be used to reduce other borrowing, fund new acquisitions or develop new products.

That said, there are disadvantages and difficulties in securitizing IPK. Many advisors and investors remain doubtful about the suitability of IPK as debt security. They find IPK difficult to value and do not see it as a particularly liquid asset.

In addition, planning, structuring and completing a securitization is time-consuming, and transaction costs are high in comparison to the cost for the IPK owner of raising debt in other ways.

However, these difficulties may reduce as the technique becomes more familiar to originators, advisors and investors. Finally, while an originator may still be retained to service the IPK, the same originator there will still be the psychological disadvantage of diverting themselves of IPK they have worked very hard to create and develop.

#### OVERCOMING PROBLEMS

A major problem occurring when IPK is put forward as security for

(indeed is sold or licensed) is valuation. A number of valuation methods can be used, but those may require the use of historical performance data and subjective assessments of future market trends and any threats from competitors. As a result, most valuations will generally be quite conservative, but one would hope that IPR will become more highly valued as valuation techniques develop.

As in any other transaction, a securitisation will involve a due-diligence exercise that will generally focus on issues relating to the ownership and transferability of the IPR and the underlying cash flows. Where rights are registered, searches can be made in the appropriate public registry. Otherwise, reliance will have to be placed on disclosure by the originator.

If transfer of the IPR to the SPV is going to be legally difficult or in-

efficient, there are alternative structures that can be put in place, although these may place restrictions on the originator's business for the term of the debt. In addition, the terms of any licences and other agreements may have to be varied. An example is issuing these do not terminate it, for example, the originator becomes insolvent and the originator is simply acting as an intermediary between the SPV and a licensee.

More general problems can occur in transaction management, particularly with originators who are securitising assets for the first time. Most securitisation transactions will take at least two months, if not substantially more, to complete. The amount of transaction documentation involved can be quite large, particularly where a large portfolio of IPR is involved, where it is multi-jurisdictional, or where contracts or licences need to be ab-

leated from or agreed with third parties. In such cases, a large amount of due diligence may also be involved. Obviously, these potential practical problems are eased where both the originator and its advisors are familiar with planning and managing large transactions.

## CONCLUSION

Securitisation should be seen as another potential way of exploiting IPR. It has advantages and disadvantages. In appropriate cases, it might be the most suitable way for a company to raise capital using its IPR. What remains to be seen, however, is how widespread securitisation of IPR will become and whether the fairly narrow classes of IPR that have been mainly securitised in the past will be widened in the future.

EXAMPLES OF DEBT FINANCE SUPPORTED BY IPR

Borrower	Intellectual Property	Transaction	Date
Beyco	Trademarks	\$400m	1991
Disney	Copyright	\$400m	1992
Uggen	Trademarks	\$250m	1992
Chemical Company	Patents	\$200m	1994
Edwin Klein	Trademarks	\$180m	1995
GE Capital	Trademarks	n/a	1995
Fashion Company	Trademarks	\$200m	1996
News Corporation	Copyright	\$200m	1996
Neith	Trademarks	n/a	1996
David Bowie	Copyright	\$50m	1997
Decca Records	Copyright	\$250m	1997
Universal	Copyright	\$1.75	1997
Real Rewards	Copyright	\$25.0m	1998
Polygram	Copyright	\$200m	1998
United Coat	Copyright	S. Life 5000	1998
New Line Cinema	Copyright	\$200m	1998
Holland-Doorn-Holland	Copyright	\$20m	1998

Source: Reference 1, and Dorian Pearce, Merrill Lynch International, London and Mark Peat, Arthur Andersen, London.