

A Primer On Intellectual Property Risk Management And Insurance

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I. Introduction

The value of intellectual property to those who exploit it effectively increased significantly in the last decade. For many businesses, "The intellectual property capacity of a company is now more valuable than its buildings, machinery, and fixed assets."¹ The increased value of intellectual property has led to increased competition for such property and increased litigation, resulting in increased risks for intellectual property owners, users, and insurers. Those risks may be grouped into five categories: (1) infringement risks—risks that a business will be compelled to pay money, halt activities, or incur substantial legal expense as a result of infringing, or being accused of infringing, the intellectual property of others; (2) enforcement risks—risks that a business will incur substantial legal expense or suffer a reduction in the value of its own intellectual property as a result of infringement by others; (3) what one might call title risks—risks that the business will not be able to maximize the value of its intellectual property as a result of its inability to convince government officials such as patent and trademark examiners, or potential licensees or purchasers, that it owns the intellectual property it claims; (4) investment risks—risks that efforts and expenditures invested in intellectual property will

not yield the expected results, or will not yield results in a way that is useful to the business; and (5) storage, maintenance, and dissemination risks—risks that a business will suffer damage to its digitally stored intellectual property.

This article explores various management devices currently available to intellectual property owners and users to mitigate infringement risks, enforcement risks, title risks, and investment risks. Section II discusses third-party insurance designed to mitigate infringement risks: commercial general liability policies; media liability policies; intellectual property infringement policies; Internet insurance policies; and litigation defense cost policies. Section III discusses insurance designed to mitigate enforcement risks: intellectual property enforcement insurance. Section IV focuses on asset securitization—one strategy businesses are beginning to employ in an effort to mitigate intellectual property investment risks.

II. Intellectual Property Infringement Insurance

One commentator posits that an efficient insurance market follows a standard three-stage chronology in response to the emergence of new risks.² First, courts stretch policy language in an attempt to adapt coverage to unforeseen circumstances, relying on the general principle that ambiguous language is construed against the insurer. Second, insurers respond to adverse case law by revising policy language to in an effort to exclude the unanticipated risks. Third, carriers develop new policies to address the new risks.³

If that is so, then we must now be at the beginning of stage three with

respect to insurance of intellectual property risks. The proliferation of the Internet and the increased importance of intellectual property to the overall economy have made intellectual property risks among the most significant for many types of businesses. Intellectual property litigation is more expensive and more prevalent.⁴

Insurers perceive that courts have stretched policy language to cover unforeseen intellectual property risks, particularly with respect to the definition of "advertising injury" in Commercial General Liability policies. They have responded by revising the language of their policies in an effort to exclude coverage for those risks.⁵ At the same time, insurers are beginning to offer new policies to address the newly significant intellectual property risks.

The result is an insurance market in flux. Rapidly changing policy language and policy availability requires increased vigilance and study of available options by insureds. It also should create concerns on behalf of both insureds and insurers about the manner in which new policy language will be interpreted and enforced by the courts.

The following are mere snapshots of certain types of insurance policies as of the writing of this article. The landscape may change even by the time this article is published, and this discussion should be considered

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with that possibility in mind.

A. Commercial General Liability Policies

Most businesses have what is called a Commercial General Liability Policy (“CGL”). A CGL insures against a wide variety of risks, many of which have nothing to do with intellectual property. The industry-wide standard form CGL policy is written by an insurance industry organization called the Insurance Services Office (“ISO”).⁶

“Certainly the current trend—and the direction in which CGL coverage has been heading for decades—is toward ever more narrow CGL coverage.”⁷ Businesses cannot depend on their CGL policy to address all of their insurance needs in the intellectual property and e-commerce areas.⁸ Intellectual property risks increasingly are becoming the subject of separate insurance policies.⁹ Nevertheless, CGL policies still do provide coverage for some intellectual property risks and therefore merit discussion in this article.

Brief History of Intellectual Property Coverage Under CGL Policies

For years, intellectual property specialists assumed, and case law supported the view, that intellectual property infringements were not covered by CGL policies.¹⁰ Although courts have continued to hold that patent infringement is not covered,¹¹ in the 1990s a number of courts held that actions for damages for copyright infringement, trademark infringement, and wrongs related to trademark infringement, such as trade dress or trade name infringement, were covered, in least in certain circumstances, by a provision in the CGL policy providing coverage for “advertising injury.”¹²

Insurers first offered coverage for “advertising injury” as an endorsement to the 1973 ISO CGL policy form.¹³ The endorsement defined “advertising injury” as “injury arising out of an offense committed during the policy period in the course of the named insured’s advertising activities, if such injury arises out of libel, slander, defamation, violation

of right of privacy, piracy, unfair competition, or infringement of copyright, title or slogan.”¹⁴

In 1986, the ISO revised the standard CGL policy language to provide coverage for advertising injury “...caused by an offense committed in the course of advertising your goods, products or services” when the injury “[arises] out of one or more of the following offenses: (1) oral or written publication of material that slanders or libels a person or organization, or disparages a person’s or organization’s goods, products or services; (2) oral or written publication of material that violates a person’s right of privacy; (3) misappropriation of advertising ideas or style of doing business; or (4) infringement of copyright, title, or slogan.”¹⁵

Court interpretation of the 1986 language was inconsistent. Some courts held that all of the insured’s marketing activities fit within the definition of “the course of advertising,”¹⁶ others limited coverage to materials more easily identified as advertisements.¹⁷

Courts also differed concerning the meaning of the phrase “misappropriation of advertising ideas or style of doing business.” Some courts interpreted that phrase broadly so as to provide coverage for offenses such as trademark and trade dress infringement.¹⁸ Others interpreted the phrase more narrowly so as to exclude those claims.¹⁹ Some steered toward the middle, holding that such claims could be, but were not necessarily covered, depending upon the relationship between the wrong and the advertising.²⁰

Some courts held that the mere fact that an advertisement displayed an infringing product triggered coverage.²¹ Other courts held that the mere fact that an advertisement displayed an infringing product did not trigger coverage.²² Other courts tried to find a middle ground on this question also, holding that display of an infringing article in advertising could trigger coverage depending on the circumstances.²³

Recent Changes to the Standard

CGL Policy

In response to the conflicting case law, the ISO revised the CGL in 1998 and then again in 2001. The 1998 revision redefined “advertising injury” to mean “the use of another’s advertising idea in your advertisement” rather than “misappropriation of another’s advertising ideas or style of doing business.”²⁴ The revised policy defined “advertisement” as “a notice that is broadcast or published to the general public or specific market segments about your goods, products or services, for the purpose of attracting customers or supporters.”²⁵ That language seems to have been designed to limit court decisions expanding the meaning of advertising to all forms of marketing.²⁶

The 1998 revision eliminated “infringement of title,” “misappropriation of the style of doing business,” and “misappropriation of advertising ideas” from the definition of “advertising injury.”²⁷ Instead the 1998 standard policy covered only “the use of another’s advertising in your advertisement” and “infringing upon another’s copyright, trade dress or slogan in your advertisement.”²⁸

The ISO revised the standard CGL policy again in 2001. The five most significant changes for intellectual property owners and users are the following. First, the new standard policy specifically excludes coverage for patent infringement, trademark infringement, copyright infringement, and trade secret misappropriation or other intellectual property rights generally. All it purports to cover is infringement in the insured’s advertisement of copyright, trade dress, or slogan.²⁹

Second, the new policy clarifies that an “advertisement” includes “material placed on the Internet or on similar electronic means of communication.”³⁰ Coverage may not, however, extend to all of the company’s website; and links to other websites, banner ads for other companies’ products, framings, and discussion of competitors’ products may be excluded, for the new policy specifies that “regarding websites,

only that part of the website that is about your goods, products or services for the purposes of attracting customers or supporters is considered an advertisement.”³¹

Third, the new policy covers web advertisements worldwide.³²

Fourth, the new policy excludes damage to electronic data from the definition of property damage, thus excluding that type of damage from coverage.³³ Electronic data is defined as “information, facts or programs stored as or on, created or used on, or transmitted to or from computer software, including systems and applications software, hard or floppy disks, CD-ROMs, tapes drives, cells, data processing devices or any other media which are used with electronically controlled equipment.”³⁴

Fifth, the new policy excludes Internet coverage for companies in Internet businesses, website designers, ISPs, search engines, and hosts of chatrooms and bulletin boards, much in the way that CGL policies historically have excluded companies in the advertising, publishing, and broadcasting businesses from advertising injury coverage.³⁵

Courts have yet to construe the new 1998 and 2001 policy language and it remains to be seen how exactly the changes in language will change coverage. It seems undeniable, however, that recent changes reflect a desire by insurers to restrict coverage for intellectual property risks under CGL policies and that businesses cannot comfortably rely on CGL policies to provide coverage for a growing number of those risks.

B. Media Liability Policies

Entities that create or exploit non-patentable intellectual property, such as media, multimedia or entertainment businesses, can purchase insurance policies specifically designed to cover the types of risks they face. Those insurance policies are typically called “media liability” policies, “errors and omissions” policies, or simply “e & o” policies. Media/Professional Insurance Agency and the Chubb Insurance Group are two of the best-known

media liability insurers. Although there is no standard media liability policy comparable to the ISO GCL policy, it is possible to make certain generalizations about media liability policies.³⁶

1. Scope of Coverage

Media liability policies generally insure against liability for a wide variety of harms resulting from dissemination of an insured’s creative works and advertising for those works, including on the Internet.³⁷ By an endorsement to the policy, media liability policies may also cover the insured’s merchandising activities. In contrast to other types of policies, media liability policies often cover claims seeking merely injunctive relief or retraction. They typically are not limited to claims for money damages.

Media liability policies generally are written on a “named peril” basis. That means they generally cover only the works specified on the insured’s application, not the insured’s business as a whole. Each work to be covered must be listed in the policy or it is not covered.³⁸

For the listed works, media liability policies typically cover liability arising out of the following causes of action, each of which must be expressly listed in the policy: copyright infringement; trademark infringement; misappropriation of ideas, titles or other items not covered by copyright; breach of an implied contract stemming from the alleged use of the submission of an idea or other material; defamation; and violation of rights of privacy and publicity. With respect to those claims, media liability insurance generally pays for the following categories of loss: litigation defense expenses (largely attorneys’ fees), including those costs incurred defending injunction motions; damages awarded to the insured’s adversary; settlement payments; and pre-judgment interest.

Should an injunction issue, wasted advertising and promotional expenses may be covered, but the insured’s economic loss resulting from an injunction, including com-

pliance costs, production costs and lost opportunity costs, will not be covered. In the event a court awards multiplied damages, the multiple portion may not be covered, but punitive damages may be covered where permitted by law.

Notable causes of action typically not covered by media liability policies are: patent infringement; false advertising; claims brought by former employees or independent contractors who created or helped create the insured’s works; and liability arising out of an express breach of contract (such as a failure to pay license fees). Coverage does not extend to “offensive” litigation costs, that is, claims that another entity has infringed the insured’s works, though certain counterclaims may be covered. In addition, coverage may not extend to: willful infringement; fraud or violation of a criminal statute; known infringement claims which arose before the policy period; anti-trust claims; or damage to computer systems or data.

Media liability policies usually cover the insured’s subsidiaries, as well as claims asserted against employees and even independent contractors such as free-lance artists and photographers, as long as the latter two were acting within the scope of their employment. Typically, a media liability policy will provide that if the insured is covered by another policy, coverage under the media liability policy is secondary.

Media liability policies generally are “occurrence” policies. This means that coverage is based on whether the activity giving rise to the claim occurred during the policy period, and that policy limits typically are tied to an individual “occurrence.”

2. Coverage Territory

Media liability policy coverage typically extends worldwide, but oftentimes coverage is limited to lawsuits brought in certain territories, typically the United States and Canada.

3. Cost

Cost varies depending on the

size of the portfolio insured and the amount of the deductible.

4. Special Considerations

On an application for media liability insurance, the applicant is likely to be required to identify any pre-existing works incorporated into the applicant's work, certify that it has performed certain clearance procedures and obtained appropriate licenses, and either list all potential claims of which it is aware or represent that it is not aware of any potential claims. That last requirement is potentially problematic because the policy application may be discoverable in litigation, as may other communications between the insured and its insurer. Responses to those questions must be carefully framed to avoid harmful admissions.

Prior to authorizing coverage, the insurer may require that an attorney certify that the insured's clearance procedures are sufficient. The insurer also may require that an attorney supervise the clearance process, including by reviewing the insured works to be certain they do not contain any defamatory material, investigating the origin and originality of the works, conducting copyright and title searches, and insuring that appropriate licenses have been purchased, appropriate releases obtained, and appropriate talent contracts have been executed.

A potential area of conflict between the insurer and the insured concerns whether the insured is obligated to mitigate damages by ceasing dissemination of a work that is accused of infringing, or whether the insurer has the right to compel the insured to print retractions in order to help resolve litigation. Sometimes, the insured will not want to cease selling its product or to print a retraction, but the insurer will want to mitigate potential damages. In recognition that certain principles often are important to media companies, the insured typically has the right to determine whether it will cease dissemination of the product or issue a retraction pre-adjudication. Unlike

many other types of insurance policies that give the insurer the right and duty to defend a claim, media liability policies sometimes give the insured the right to defend if it chooses and may even require the insured to notify the carrier if it does not want to defend.

C. IP Infringement Policies

In the last several years a number of insurance companies, including Chubb, AIG, InsureTrust (through Lloyd's of London), Venture Programs, Intellectual Property Risk Management ("IPRM"), and Litigation Risk Management, Inc. ("LRM") have begun offering insurance that pays costs associated with infringement of patents only, or infringement of some combination or all of patents, trademarks, trade dress, copyrights and trade secrets. For purposes of this article we will refer to these policies as "IP infringement policies." IP infringement policies vary by carrier and property covered. The following descriptions are necessarily general and somewhat abstract.³⁹

1. Scope of Coverage

IP infringement policies typically cover the costs of infringement arising from the use, distribution, sale, or advertising of the insured's products. Many exclude coverage for trade secret misappropriation. Most insure against liability for: defense expenses (largely attorneys' and expert's fees), including costs incurred defending injunction motions; damage awards; and settlement expenses. Each of the aforementioned categories typically counts against the total amount of the coverage. Thus, the amount of the indemnity remaining to pay damages will be reduced by the cost of an unsuccessful defense. That fact is more important in the patent infringement context because patent infringement lawsuits tend to be more expensive than copyright and trademark infringement lawsuits.

As with media liability policies, IP infringement policies typically are issued on a named peril basis. Coverage may not extend to: will-

ful infringements; claims based on a failure to pay royalties; criminal acts; or known prior infringements.⁴⁰ As with media liability insurance, however, infringements prior to the date of the policy may be covered if the insured pays for that additional coverage. Coverage typically is on a "claims made" or "claims made and reported basis." For claims to be covered, they must be made, or both made and reported, within the policy period.

2. Covered Territory

The covered territory generally is limited to the United States, although in some cases the insured may extend the territory by endorsement.

3. Cost and Indemnity Limits

IP infringement insurance can be expensive. The cost may be as much as, if not more than, \$3,000 annually for each patent insured or upwards of \$40,000 a year per product line for those companies that offer coverage on that basis. Policy limits range from \$100,000 to \$50,000,000.

4. Special Considerations

IP infringement policies typically do not cover the costs of complying with an injunction or settlement promise to cease and desist. Typically, applications require detailed information about the legal compliance program the insured uses to guard against infringement, the applicant's past history of infringement, and the applicant's own patents. The answers to these questions can affect the cost and availability of coverage. The applicant may also be required to supply opinion letters regarding non-infringement.

A shortcoming of some IP infringement policies is that reimbursement to the insured may not be due until final disposition of a claim. That can eviscerate some of the value of obtaining patent infringement insurance if the insured's attorney is not willing to wait for payment. As with media liability policies, the insurer typically has the right to limit coverage to the amount of a proposed settlement, plus expenses incurred prior to receipt of the offer,

if the insured refuses to accept a settlement offer.

D. Internet Insurance Policies

In some ways, ubiquitous use of the Internet changes intellectual property risks very little. Just as traditional legal principles have been adapted to most legal issues, such as personal jurisdiction on the Internet, so too do traditional legal principles apply to Internet-related intellectual property issues. Intellectual property content providers on the Internet must address the same copyright and trademark concerns that multimedia providers previously have addressed. They must license the music and images they use; they must clear their use of any names or likenesses; and they cannot label their products in a confusing way.

There are, however, risks unique to the Internet. The Internet by its very nature is global. Thus, if a business is planning to disseminate intellectual property on the Internet an insurance policy covering only the United States is inadequate; coverage must be worldwide. In addition, many businesses that traditionally have not been intellectual property users now maintain websites that may utilize intellectual property. Unaccustomed as they are to the use and protection of intellectual property, such businesses must learn to obtain licenses for the use of others' software, music, and visual materials on their websites. They may also need to obtain insurance.⁴¹

A number of carriers, including the Chubb Insurance Group, AIG, Tech Shield (through AON), InsureTrust, Media/Professional Insurance Agency, and St. Paul Fire and Marine Insurance Company now offer "Internet insurance" or "cyber-risk" insurance policies to businesses that use the Internet, but that are not pure Internet businesses such as internet service providers, hosts, or website developers.⁴² These policies are just as new, and just as varying as IP infringement policies⁴³ and therefore the following generalizations may not apply

in all instances.⁴⁴

1. Scope of Coverage

Internet insurance policies are designed to indemnify businesses with respect to liabilities and defense costs for intellectual property infringements and other wrongs such as defamation, invasion of privacy, and unfair competition, committed in connection with the display, transmission, or other use of material on the Internet. One policy covers liability incurred as a result of improper deep linking or framing, but most do not.⁴⁵ Such policies often specifically exclude coverage for patent infringement, trade secret misappropriation, false advertising, and claims for breach of contract or failure to pay royalties.

As with IP infringement policies, the multiplied portion of any damage award, and any criminal penalties may be excluded from coverage, although some insurers will pay multiple damages and even punitive damages where it is legal to do so. Policies also sometimes exclude coverage for any award of lost profits.

Typically, Internet insurance policies are "claims made" policies, meaning that coverage applies only to claims brought within the term of the policy, or "claims made and reported policies," meaning that coverage applies only to claims both made against the insured and reported to the insurer during the policy period.

Some policies may be extended to cover distribution of materials by additional means such as printed copies and CD-ROMS. Internet insurance policies also may cover liability to third parties for things such as damages caused by the transmission of a virus, exchange of corrupted data, and unwitting participation in denial of service attacks.

Some Internet insurance policies provide that the insurer has the right and duty to defend lawsuits involving covered activities; others provide that the insurer has the right, but not the duty, to defend. The insured may settle only with the

consent of the insured, but may cap its liability at the amount rejected by the insured.

2. Coverage Territory

Coverage typically is, as it must be, worldwide.

3. Cost

Premiums range from \$5,000 to upwards of \$100,000 annually and vary widely according to the business and the scope of coverage actually obtained.⁴⁶

4. Practical Considerations

Because Internet insurance is so new, policies vary significantly and there is little case law interpreting their provisions.⁴⁷ It remains to be seen how coverage disputes will be decided. Many of the insurers require policyholders to have their systems audited by independent technical experts and to have their systems reviewed periodically as a condition to granting coverage for damages caused by the transmission of a virus, exchange of corrupted data, and participation in denial of service attacks.⁴⁸

E. IPISC's Defense-Cost Only Insurance

Another risk management option available to intellectual property owners is defense cost reimbursement insurance, insurance designed to cover only the costs of defending a patent infringement lawsuit. Defense cost reimbursement insurance is marketed as the solution for a company that knows it is in the right but is concerned that it cannot afford to litigate against a bigger or more well financed adversary. The insurance is not widely available. The author knows of only one company that offers such a policy, IPISC.

The costs covered include attorneys' fees, expert fees, and other litigation expenses. IPISC does not reimburse the insured for any damages it may be required to pay if it loses the lawsuit, although such coverage may be added. Premiums for defense cost insurance can range from approximately \$2,500 to approximately \$20,000 a year for

coverage limits of between \$250,000 and \$500,000. The application for this insurance requires the applicant to attach an opinion of non-infringement. The insured is required to supply a second opinion when it submits a claim.

III. IP Enforcement Insurance

Many businesses cannot afford the expense of prosecuting an infringement suit, particularly a patent infringement lawsuit and particularly against a larger or better-financed adversary, even if attorneys' fees may be recovered in the end.⁴⁹ That problem is exacerbated by the fact that few intellectual property lawyers are willing to litigate on a contingency fee basis. In response to this state of affairs several companies are writing insurance policies specifically designed to cover the cost of prosecuting infringement litigation, IP enforcement insurance.

Intellectual property enforcement insurance is insurance that pays for the cost of prosecuting infringement actions. It is designed to enable those businesses that can afford the premiums, but not the costs of a lawsuit, to vigorously enforce their rights. IP enforcement insurance is a new product, and only a few companies offer it. Those companies include Litigation Risk Management, Inc. ("LRM"), IPISC, AON Corporation and, in Canada, Binks Insurance Brokers Ltd.⁵⁰

IP enforcement insurance is not available everywhere. It is not, for example, available in New York.⁵¹ Whether such insurance becomes more widely available, and whether such availability leads to increased litigation, remains to be seen.

1. Scope of Coverage

Intellectual property enforcement policies cover a percentage (typically 80%) of the insured's cost of prosecuting an infringement action, including attorneys' fees, expert witness fees, deposition and court costs, and any costs incurred in defending against a patent invalidity counterclaim. The insured must pay the balance. The insurance may cover the same percentage of the defense of a declaratory judgment action,

provided the insured can assert a counterclaim for infringement, that is, provided that there is potential for monetary recovery. IP enforcement policies do not cover liabilities for judgments or damages; they pay only the costs of an infringement suit.

Policies typically are "claims made" policies; the infringement must be discovered, and the suit must begin, during the policy period.⁵² Policies may cover various types of intellectual property, or patents only. Policies may cover either individual properties or a portfolio of properties.

2. Covered Territory

The covered territory varies, and may be varied by endorsement. IPISC's standard coverage, for example, is limited to the United States. AON and LRM cover worldwide.

3. Premiums and Limits

For IPISC's policy covering individually named items, coverage ranges from \$100,000 up to \$500,000. IPISC charges premiums ranging from roughly \$1,300 to \$9,800 per insured property. LRM charges premiums of between \$30,000 and \$150,000 per year for coverage of a "commercial family of patents" with no known infringements; policy limits can be as high as \$7.5 million.

4. Special Considerations

As one might expect, insurers that fund litigation demand certain participation in the process. They also share in the recovery.

IPISC, for example, requires that it be given the right to approve any litigation that is to be covered and requires the submission of a substantial amount of detailed information, as well as the opinion of an independent counsel, before giving its approval. LRM uses a different approach. It conducts an extensive analysis of the insured's properties, paid for by the insured, before issuing the policy. The insured must pay typically between \$25,000 and \$37,000, plus expenses, for an opinion on the strength of its property prior to receiving coverage.

LRM's method undoubtedly costs more initially, but it may make for greater efficiency when it is time to commence litigation.

Insurers typically recover their expenses from a portion of any recovery. IPISC, for example, shares pro rata in any recovery that the insured obtains, up to one and a half times the amount it spends on the litigation costs. IPISC policies also have a provision (which may be eliminated by endorsement) that allows it to charge the insured for the "economic benefit" the insured receives as a result of obtaining an injunction or other relief that benefits the insured economically, despite the fact that such benefit may not be quantifiable. The policy provides that if such "economic benefit" cannot be calculated, it will be presumed to be one and a half times what the insurer spent on the litigation.

Few cases have analyzed coverage issues with respect to this type of insurance, leaving uncertainty as to how such disputes will be resolved.⁵³

IV. Intellectual Property Securitization

Intellectual property rights owners whose properties generate sufficient consistent revenues, and who want to convert those consistent revenue streams into up-front cash, can issue bonds secured by the revenues actually generated, or in some cases expected to be generated by those assets. The process is known as asset securitization.

Intellectual property asset securitization works basically as follows. The intellectual property owner transfers the rights to receive licensing revenues for a fixed period of time to a separate entity, commonly referred to as an SPV (Special Purpose Vehicle).⁵⁴ That transfer must qualify as a "true sale" to insure that the assets are not available to creditors in the event the intellectual property owner becomes bankrupt.⁵⁵ The SPV may be a trust, partnership, limited liability company, or corporation; for tax reasons it often is an entity other than

a corporation. The SPV, in turn, issues bonds to raise the capital to pay the intellectual property owner for the rights transferred, usually in a private placement.⁵⁶ Bondholders typically receive a security interest in the intellectual property. In addition, payments to bondholders may be guaranteed either by a related entity or third party, or bondholders may be offered insurance for the risk of default, or both.⁵⁷

The two most significant benefits of intellectual property asset securitization may be that it generates for the intellectual property owner increased liquidity and it allows the intellectual property owner to access credit based solely on the earning power of its intellectual property and divorced from any credit difficulties the company may be experiencing overall.⁵⁸ Thus, a SPV created by a company with a less favorable credit rating may be able to achieve a better rating, and thus access to funding a lower interest rate or even access to funding that might not otherwise have been available at all.⁵⁹ In addition, the transaction may generate favorable tax treatment; the payments from the bondholders are treated as a loan, interest paid bondholders may be deductible, and income is recognized only upon receipt of royalties.⁶⁰ Another plus is that the funds generated by such financings generally are unrestricted; the borrower can use the funds for whatever business purpose.

Securitization can help businesses obtain funds needed for further research and product development, and share the risks of unforeseen market developments.⁶¹ Securitization can be attractive to individual artists not only because it allows them instant access to cash, but also for tax and estate planning purposes.⁶²

These types of deals are not, however, for everyone. A prerequisite is that the intellectual property used to secure the loan must have a history of consistently high revenues.⁶³ Underwriters generally require minimum annual revenues of \$1,000,000.⁶⁴ In addition, it is important that the issuing entity have

sound documentation concerning its rights and revenues (another reason to institute a legal compliance program).⁶⁵

Moreover, intellectual property asset securitizations are complex transactions.⁶⁶ They require intense due diligence and difficult calculations concerning potential future income streams.⁶⁷ Nigel Butterfield, Chrysalis Group's Finance Director, was quoted as saying about the work involved in completing Chrysalis' securitization: "After 18 months, I'm never going to do that again...It was the most difficult thing I've done in my life."⁶⁸

One of the disadvantages of asset securitization is that the intellectual property typically becomes collateral for the bonds.⁶⁹ Assets used to secure the bonds are encumbered for the duration of the loan and generally cannot be used as collateral on other deals. A related concern is that the deals done to date generally have been over collateralized; assets have been pledged to support an issuance based on only a percentage of their typical cash flow.⁷⁰ Also, bondholders may impose onerous restrictions on the company's ability to vary the terms of its licenses or otherwise exploit the intellectual property.⁷¹ Another concern is that asset securitizations are off-balance sheet transactions, an issue of heightened sensitivity in light of the Enron scandal.⁷²

Intellectual property asset securitization is a new business. The first deal, or at least the first well-publicized deal, was completed only in 1997, when David Bowie successfully issued \$55 million in bonds secured by the royalty stream earned by the twenty-five albums he recorded before 1990.⁷³ When news broke of the Bowie bonds in 1997, some believed that large numbers of businesses and individuals would rush to securitize their intellectual property. They saw tremendous potential for bond issuances based on the catalogs of large record companies and movie studios, as well as bond issuances by technology companies. "What the Bowie bonds show," said David

Pullman, then managing director of the Bowie bonds' issuing bank, "is that intellectual property of all kinds can be securitized."⁷⁴

Since the Bowie bond issuance a small number of companies have entered into a variety of intellectual property asset securitizations. Walt Disney sold bonds with returns linked to a pool of its films.⁷⁵ Candies sold bonds secured by licensing revenues generated by its trademarks, as did Bill Blass.⁷⁶ Dreamworks securitized the film rights and future revenues of a series of films pre-release.⁷⁷ The Dreamworks deal was significant because it involved securitization based solely on projected future earnings, allowing for far less precise valuation, thereby demonstrating increased investor confidence in intellectual property values. Sesame Workshop securitized royalties derived from long-term trademark licensing contracts for its Sesame Street brand.⁷⁸ Perry Ellis issued bonds backed by its intellectual property to fund its acquisition of Jantzen Inc.⁷⁹ The owner of the Arby's fast food chain completed a \$290 million private placement securitized by franchising revenues.⁸⁰ Chrysalis issued bonds backed by the revenue streams generated by its music publishing catalog.⁸¹

Those transactions notwithstanding, to date relatively few intellectual property owners have issued asset backed securities. "At present, the markets for intellectual property asset-based securities are small, as the universe of buyers and sellers is limited."⁸² Only one patent securitization arrangement is known to have been completed.⁸³ And there still are only a handful of firms with expertise concerning intellectual property asset backed securities.⁸⁴ With respect to artist royalty securitizations the Pullman Group, which itself claims only a handful of such issuances, claims to be the only entity to have accomplished the task.⁸⁵

Moreover, intellectual property asset securitizations have not been without their problems. Cash flows on only known patent securitization,

that created by Yale University (involving its patent for an HIV medication) fell below expectations when Yale's licensee, Bristol Myers Squibb, sold its entire inventory to wholesalers at a substantial discount to reach corporate earnings goals, resulting in diminished profits. That threatened to trigger an early amortization clause, diminishing investors' returns. However, because payments were insured, bondholders were expected to recover the entirety of the principal.⁸⁶

Sale/License Back

Another type of financing available for consideration by intellectual property owners is a sale/license back arrangement.⁸⁷ The concept is said to be similar to real estate sale/lease back arrangements. Only a handful of those deals are known to have closed.⁸⁸ Companies known to be involved in those types of transactions are TEAUS, Licent Capital and TEQ Development.

V. Conclusion

Modern intellectual property risks threaten both the ability of a business to preserve intellectual property values and its ability to enhance those values. Businesses can manage those risks by adopting legal compliance programs, by purchasing insurance and by pursuing creative financing plans. Each business must select the method (or methods) of risk management that best serves that business from all of the available devices. The business must review its selections frequently because intellectual property risk management devices continually are evolving and new risk management devices are likely to become available.

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