

**MAKING SOMETHING OUT OF “NOTHING”  
THE TREND TOWARDS SECURITIZING INTELLECTUAL PROPERTY ASSETS  
AND THE LEGAL OBSTACLES THAT REMAIN**

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**I. INTRODUCTION**

Since the concept first debuted in the 1970s, asset securitization has become an increasingly common mechanism for companies to raise capital, particularly as the range of securitizable assets has expanded dramatically.<sup>3</sup> Today, companies are able to securitize everything from residential mortgages to leases, auto loan and credit card receivables, commercial mortgages, equipment leases, franchise fees, state lottery winnings and litigation settlement payments.<sup>4</sup> More recently, less conventional assets have also been targeted by bond issuers and investors alike as security for structured finance transactions.<sup>5</sup> Such unconventional assets include revenues from oil and gas reserves, as well as the cash flows derived from intellectual property assets in the form of royalty payments from patents, trademarks and copyrights.<sup>6</sup>

While the mechanics of structuring traditional asset securitizations are well-established,<sup>7</sup> intellectual property (IP) securitizations raise a host of complex issues that must be resolved before this particular asset class can be leveraged on a more regular basis. Underlying these issues is the very nature of intellectual property as an intangible asset. Though IP assets may be related to certain tangible assets (for example, a copyright in a song produces a corresponding CD), they are legally distinct from them and must be treated separately in a securitization. Consequently, the parties to an IP securitization face unique complexities with respect to the transfer of the assets into the “special purpose vehicle” that is structured for the transaction, and with respect to the bondholders’ ability to take a secured interest in the IP collateral.

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<sup>3</sup> STEVEN L. SCHWARCZ, *STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION* 1-7 (Adam D. Ford ed., Practising Law Institute 2003) (1990).

<sup>4</sup> Edward M. Iacobucci & Ralph A. Winter, *Asset Securitization and Asymmetric Information*, 34 J. LEGAL STUD. 161, 162 (2005).

<sup>5</sup> *Id.* at 162.

<sup>6</sup> *Id.* at 162.

<sup>7</sup> SCHWARCZ, *supra* note 3, at 1-7.

These complexities also vary in degree based upon the specific IP assets that are being securitized. Copyrights, for example, tend to represent the most difficult class of IP assets to securitize because the federal copyright regime preempts most provisions of state secured credit law, despite the fact that the Copyright Act of 1976, which ushered in the modern era of copyright law, was plainly not designed to facilitate such transactions. Patents are much easier to securitize from a legal perspective, but are accompanied by a significant amount of business risk. Finally, trademark securitizations represent the most common form of IP securitizations, both because trademark law is relatively straightforward compared to the copyright regime and because the business risks inherent in patents are not present in trademarks. Nevertheless, trademark law does include several obstacles that must be overcome in order to enable the continued proliferation of trademark securitizations.

This article will undertake a thorough review of the issues associated with securitizing IP assets in order to promote a better understanding of these transactions and of their usefulness in an economy that places increasing value on companies' intellectual property holdings. The analysis of intellectual property securitizations begins with a review of how securitizations are structured and of the benefits of securitizations to both originators and investors. This article then describes the history of intellectual property securitizations and the current trends in completing such transactions. Following up on this background information, this article focuses on what makes IP securitizations unique compared to the securitizations of other assets, and also discusses the various legal regimes that parties to intellectual property securitizations must comply with in order to complete them successfully. The next section of the article conducts an in-depth examination of the mechanics of transferring ownership in copyrights, patents and trademark assets, respectively, from the originator to the special purpose vehicle, which is responsible for issuing the bonds. Once the assets have been transferred into the special purpose vehicle, this article considers how investors are able to attach a security interest in intellectual property assets pursuant to Article 9 of the Uniform Commercial Code, and how the investors successfully perfect their security interest in copyrights, patents and trademarks, respectively. As the last step in the securitization process, this article discusses how the parties to a securitization calculate the value of the intellectual property assets owned by the special purpose vehicle. Finally, this article concludes its review of the issues facing intellectual property securitizations by discussing their future in the marketplace. This conclusion is highlighted by a consideration of how legislative reform may increase the frequency of these types of transactions, and by an explanation of how the proliferation of intellectual property securitizations promotes technological innovation and companies that build value by exploiting their intellectual property assets through licensing opportunities.

## II. BACKGROUND TO SECURITIZATIONS

### A. STRUCTURING A SECURITIZATION

Asset securitization is an established mechanism for corporations to access capital by borrowing against future income streams.<sup>8</sup> The first step in structuring such a transaction is to identify and isolate a pool of assets against which a corporation, known as the “originator,” can borrow funds.<sup>9</sup> Asset pools qualify for securitization if they have a predictable future income stream associated with them and if they are easy to isolate. Conventional securitizable assets include residential mortgage leases, auto loan and credit card receivables, commercial mortgages, equipment leases, franchise fees, state lottery winnings and litigation settlement payments.<sup>10</sup> All of these assets are similar in nature because they represent payment obligations, in the form of receivables, from third parties known as “obligors.”<sup>11</sup>

One of the underlying purposes behind a securitization is to protect the securitized assets from the insolvency of the originator. Thus, once they have been properly identified, the originator completes an arms-length “true sale” of the assets into a wholly owned subsidiary corporation known as a special purpose vehicle (“SPV”). The principal feature of the SPV is that it is “bankruptcy remote,” and therefore shielded from the originator’s creditors in the event the originator becomes insolvent.<sup>12</sup> This structure serves to distinguish a securitization from a simple secured loan. If a true sale had not been completed, and the SPV only had a security interest in the receivables but not ownership, then in the event of the originator’s bankruptcy the originator could prevent the SPV from gaining access to the receivables, by filing for a stay under section 362 of the U.S. Bankruptcy Code.<sup>13</sup> Conversely, if the assets have been properly sold to the SPV, then the originator cannot prevent the SPV from gaining access to the receivables in the event of the originator’s bankruptcy, because the receivables are no longer considered part of its bankruptcy estate.<sup>14</sup>

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<sup>8</sup> Peter J. Lahny IV, *Asset Securitization: A Discussion of the Traditional Bankruptcy Attacks and an Analysis of the Next Potential Attack, Substantive Consolidation*, 9 AM. BANKR. INST. L. REV. 815, 815-16 (2001).

<sup>9</sup> *Id.* at 816.

<sup>10</sup> Iacobucci & Winter, *supra* note 4, at 162.

<sup>11</sup> SCHWARCZ, *supra* note 3, at 1-4.

<sup>12</sup> Lahny IV, *supra* note 8, at 816.

<sup>13</sup> Iacobucci & Winter, *supra* note 4, at 165.

<sup>14</sup> *Id.* at 165.

Practically speaking, the true sale determination takes the form of a legal opinion that is subject to challenge only in the event of bankruptcy.<sup>15</sup> Though it is not always an easy task, the following considerations are typically undertaken to determine whether a true sale has occurred: whether the transfer of assets resulted in the actual transfer of risk from the originator to the SPV; which entity is now responsible for collecting the receivable payments; and how susceptible the SPV is to bankruptcy itself.<sup>16</sup> In assessing whether a transfer of risk has taken place, for example, the less recourse that a security investor in the SPV has to the originator for late or unpaid repayments of the receivables owned by the SPV, the more likely it is that a true sale has taken place.<sup>17</sup> On the other hand, if the receivables generate a surplus after payment to the securities investors, then a positive true sale determination can be made more readily if the surplus stays within the SPV rather than winding up in the hands of the originator.<sup>18</sup>

A true sale is also more likely to have occurred if the SPV retains control over collecting the accounts, or if the originator collects the accounts subject to the SPV's sole discretion.<sup>19</sup> Finally, the lower the probability that the SPV will file for bankruptcy, the more likely it is that a positive true sale determination will be made.<sup>20</sup> The SPV can be prevented from filing for voluntary bankruptcy under section 301 of the Bankruptcy Code at the behest of the originator, if ownership and control of the SPV are not put in the hands of the originator.<sup>21</sup> Even if the originator retains ownership of the SPV, however, restrictions can be placed upon the SPV that limit its ability to file voluntarily for bankruptcy protection by including, for example, a provision in the SPV's charter that prohibits the voluntary filing of bankruptcy unless a certain number of independent directors first agree to do so. The SPV can also be protected from being forced into bankruptcy by unpaid creditors by limiting the business in which it engages.<sup>22</sup> Lastly, bankruptcy remoteness is reinforced through the issuance of a legal "non-consolidation" opinion, which assures investors and ratings agencies that the SPV

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<sup>15</sup> See Steven L. Schwarcz, *The Limits of Lawyering: Legal Opinions in Structured Finance*, 84 TEX. L. REV. 1, 1-3 (2005).

<sup>16</sup> Iacobucci & Winter, *supra* note 4, at 166-67.

<sup>17</sup> *Id.* at 166.

<sup>18</sup> *Id.* at 166.

<sup>19</sup> *Id.* at 167.

<sup>20</sup> *Id.* at 167.

<sup>21</sup> *Id.* at 167.

<sup>22</sup> *Id.* at 167-68.

and originator will not be consolidated by the court in the event of a bankruptcy filing.<sup>23</sup>

The SPV manages the purchase of the assets by issuing debt securities or debt-like instruments in the bond market or to private institutional investors, and applying the cash raised to the payment to the originator.<sup>24</sup> Investors in the SPV's securities are paid back through collections on the receivables purchased by the SPV and paid by the obligors.<sup>25</sup> Because of this structure, investors base their decision on whether to purchase the securities by analyzing the underlying quality and predictability of the receivable payments, instead of focusing primarily on the credit rating of the originator corporation.<sup>26</sup> This risk assessment involves a consideration of the aggregate rate of default of the receivables and the size of the pool of the receivables. Generally, a larger pool of receivables has a lower risk of default than a more concentrated number of receivables due from a few obligors.<sup>27</sup>

Article 9 of the Uniform Commercial Code ("UCC") governs the security interest that the SPV's creditors are granted in the assets of the SPV, so long as the assets are considered personal property.<sup>28</sup> Pursuant to section 9-102(a) of this statute, the collateral that is available in the SPV can fall within several categories. For example, because the securitized assets typically include the right to a payment obligation that has been sold by the originator, the assets qualify as "accounts" under section 9-102(a)(2).<sup>29</sup> That section describes accounts as "a right to payment of a monetary obligation...for property that has been or is to be sold, leased, licensed, assigned or otherwise disposed of."<sup>30</sup> In addition to the payment obligation, the creditor may also take a security interest in the underlying assets that generate the income stream, so long as they have been transferred into the SPV. In certain instances, such as with mortgage-backed securities, Article 9 will govern the security interest in the payment obligation but not in the underlying asset because the underlying asset qualifies as real property. In other cases, however, such as with the sale of trademark licensing

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<sup>23</sup> Lahny IV, *supra* note 8, at 880.

<sup>24</sup> *Id.* at 816.

<sup>25</sup> SCHWARCZ, *supra* note 3, at 1-5.

<sup>26</sup> *Id.* at 1-5.

<sup>27</sup> *Id.* at 1-5.

<sup>28</sup> Raymond T. Nimmer, *Revised Article 9 and Intellectual Property Asset Financing*, 53 ME. L. REV. 287, 308-09 (2001).

<sup>29</sup> Steven O. Weise, *The Financing of Intellectual Property Under Revised UCC Article 9*, 74 CHI-KEN L. REV. 1077, 1086-88 (1999).

<sup>30</sup> U.C.C. § 9-102(a)(2) (2001).

royalties into an SPV, Article 9 governs both the security interest in the royalty income stream and the underlying trademark assets because both fall under personal property categories under section 9-102(a).<sup>31</sup>

## B. BENEFITS OF SECURITIZATIONS

By transferring the assets to a separate entity, the originator is able to raise funds at a lower cost of capital than it might otherwise have been able. Because the SPV is bankruptcy remote from the originator, the investment rating of the SPV's securities can be, and typically are, rated higher than the originator's underlying credit rating, and therefore command a lower interest rate than the originator's own securities, bank lines of credit or secured borrowings.<sup>32</sup> Ratings agencies calculate the independent rating (i.e., independent from the originator) for an SPV based on a range of factors besides the sufficiency of the asset sale to the SPV. These factors include the creditworthiness of the transferred assets; the value of any credit enhancements on the assets;<sup>33</sup> the probability of default on the payments of the securities; and the ultimate recovery and timing of the recovery of the assets pledged as collateral.<sup>34</sup>

Put another way, the sale of the IP assets into the SPV represents a means of shielding a company's intellectual property assets from the risks associated with operating the company, while keeping the value of the IP assets intact. The value of a trademark, for example, is inherently bound to the products that the trademark symbolizes; however, by moving the trademark into an SPV it is no longer subject to the risks associated with manufacturing and distributing the products. Once the SPV has been created, in fact, the originator becomes just another third party licensee who is required to pay royalty fees into the SPV for the use of the SPV's intellectual property assets. As discussed more fully below in the concluding section of this article concerning how IP securitizations encourage innovation, this structure allows companies not only to mitigate the risk associated with their IP assets, but also to focus on building value through the exploitation of their intellectual property.

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<sup>31</sup> U.C.C. § 9-102(a)(2), (42)

<sup>32</sup> SCHWARCZ, *supra* note 3, at 1-5.

<sup>33</sup> Credit enhancements are designed to reduce the credit risk of an obligation and thereby improve the credit rating the assets receive. Credit enhancements generally take one of two forms: third party guarantees of repayment or overcollateralization by the bond issuer. Overcollateralization occurs when the issuer pledges assets with a book value greater than the value of the bonds. *DICTIONARY OF BANKING TERMS*, (Barron's Educational Series, Inc. 2006), available at <http://www.answers.com/topic/credit-enhancement> (last visited April 06, 2007).

<sup>34</sup> Lahny IV, *supra* note 8, at 826-27.

Because of the asset sale to the SPV, securitizations also represent a means for an originator to raise additional debt financing without breaching restrictive covenants that it may have entered into limiting the level of debt that it is allowed to incur.<sup>35</sup> Securitization transactions are also beneficial to the originator because they enable the originator to attract new financing sources that are interested in investing in the asset-backed securities, but that might not otherwise have considered investing in the originator itself.<sup>36</sup> Inherent to its structure, the securitization provides the originator with current cash based on future payment streams, which the originator can then deploy for working capital or other special projects.<sup>37</sup> Lastly, securitizations represent an off-balance sheet form of financing, unlike a secured loan, because the originator is replacing one asset, the future stream of income, with another asset, cash.<sup>38</sup> Off-balance sheet financing is attractive to the originator because it does not increase the originator's debt-to-equity ratio, and therefore has no negative impact on the originator's creditworthiness.<sup>39</sup>

From an investor's perspective, securitizations are attractive because they represent a fixed income investment, meaning they have a constant rate of return. Pooling the assets into groups of receivables also mitigates the risk that any one receivable will fail and jeopardize the ability of the investor to have its debt payments satisfied. Lastly, because the SPV is bankruptcy remote, the receivable payments into the SPV are protected from claims by creditors of the originating entity and therefore increase the likelihood that the securitization investors will be paid.

### III. HISTORY OF INTELLECTUAL PROPERTY SECURITIZATIONS

Asset securitization was first introduced to the market in 1970, when the Government National Mortgage Association ("Ginnie Mae") began publicly trading "pass-through" securities.<sup>40</sup> Pass-through securities involved investors who purchased an interest in a pool of mortgage loans in exchange for a share of the interest income and principal payments generated by the underlying mortgages.<sup>41</sup> Pools of mortgages were originated by mortgage lenders, and were

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<sup>35</sup> SCHWARCZ, *supra* note 3, at 1-5.

<sup>36</sup> Lahny IV, *supra* note 8, at 824-25.

<sup>37</sup> *Id.* at 825-26.

<sup>38</sup> *Id.* at 827.

<sup>39</sup> *Id.* at 827-28.

<sup>40</sup> SCHWARCZ, *supra* note 3, at 1-8.

<sup>41</sup> *Id.* at 1-8.

composed of mortgages with similar characteristics in terms of duration, quality and interest rate. Analogous to the contemporary SPV structure, the pool of mortgages was placed in a trust which then sold certificates of ownership in the trust to investors.<sup>42</sup>

Though the pass-through securities were a novel financing mechanism when they were introduced in 1970, the need for them had been fomenting in the housing market since the Great Depression. Prior to 1929, mortgages were typically provided by savings and loan associations that relied too heavily on core deposit flows for the funds to finance their mortgage lending activities.<sup>43</sup> After the housing market crashed along with the rest of the American economy, Congress created a secondary market in mortgages through passage of the National Housing Act of 1934.<sup>44</sup> The secondary mortgage market helped to alleviate the risk associated with mortgage lending by allowing secondary institutions to guarantee the loans. Thus, in 1938, the Federal National Mortgage Association (“Fannie Mae”) was created by Congress to guarantee mortgages by purchasing mortgages from the originators when funds were low, and by selling them when funds were high.<sup>45</sup> In 1968, Ginnie Mae was spun-off from Fannie Mae to pool together and securitize mortgage loans provided primarily by the Federal Housing Authority and the Department of Veteran Affairs. Ginnie Mae guaranteed investors in its mortgage-backed securities the timely payment of principal and interest, and also offered the only mortgage-backed securities to carry the “full faith and credit guaranty” of the United States government, which made the securities extremely low risk.<sup>46</sup>

By pooling a diverse range of mortgages into securitization instruments guaranteed by the government, mortgage-backed securities substantially reduced the risk of mortgage lending and led to an exponential growth in the home market. Mortgages also became available to low income households who previously had been unable to afford mortgages because of high interest rates.<sup>47</sup>

Since the 1970s, the range of securitizable assets has increased dramatically, and today, lease, auto loan and credit card receivables, commercial mortgages, equipment leases, franchise fees, state lottery winnings and litigation

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<sup>42</sup> *Id.* at 1-8.

<sup>43</sup> *Id.* at 1-7.

<sup>44</sup> *Id.* at 1-7.

<sup>45</sup> *Id.* at 1-7.

<sup>46</sup> About Ginnie Mae, <http://www.ginniemae.gov/about/about.asp?Section=About> (last visited April 06, 2007)

<sup>47</sup> *Id.*

settlement payments are all presented as standard collateral in structured finance transactions. More recently, less conventional assets have also been targeted by issuers and investors alike as security for structured finance transactions. Such unconventional assets include revenues from oil and gas reserves, as well as the cash flows derived from intellectual property assets in the form of royalty payments from patents, trademarks and copyrights.<sup>48</sup>

In 1997, the market for intellectual property securitizations was inaugurated with a splash when singer/songwriter David Bowie securitized his prolific catalog of recordings and song copyrights, and the royalties generated by them, in a \$55 million deal known as the “Bowie Bonds.”<sup>49</sup> The bonds featured a ten year duration and a 7.9 percent coupon.<sup>50</sup> EMI Music Publishing provided a credit enhancement to the Bowie Bonds by pledging its own creditworthiness and guaranteeing repayment of the bonds, which enabled the Bowie Bonds to achieve an A3 credit rating.<sup>51</sup> Prudential Insurance purchased the bonds through a traditional private placement.<sup>52</sup>

Despite the widespread publicity that the Bowie Bonds generated, only several single artist music royalty securitizations subsequently took place. In 1998, Holland Dozier Holland issued an \$18 million bond securitized by a catalog of 300 of their songs and payable over a 15 year time period.<sup>53</sup> Then in 1999, Iron Maiden issued \$30 million in 18-year unrated bonds with a 7.4 percent coupon.<sup>54</sup>

The lack of volume in these types of transactions is due in part to the volatile personality attributed to the mastermind behind the Bowie Bonds, David Pullman, who faced mounting criticism and lawsuits from prospective clients for failing to close transactions.<sup>55</sup> The investor market for music royalty securitizations also chilled after the Bowie Bonds were downgraded in 2004. The downgrade occurred when EMI, which had credit enhanced the bond deal,

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<sup>48</sup> Iacobucci & Winter, *supra* note 4, at 162.

<sup>49</sup> Nicole Chu, *Bowie Bonds: A Key to Unlocking, the Wealth of Intellectual Property*, 21 HASTINGS COMM. & ENT. L.J. 469, 470 (1999).

<sup>50</sup> Teresa N. Kerr, *Bowie Bonding in the Music Biz: Will Music Royalty Securitization be the Key to the Gold for Music Industry Participants?*, 7 UCLA ENT. L REV. 367, 381 (2000).

<sup>51</sup> Chu, *supra* note 49, at 471.

<sup>52</sup> *Id.* at 471.

<sup>53</sup> Jeremy Grant & Alice Rawsthorn, *Bonds Have More Fun as Banks Rock ‘n’ Roll*, FINANCIAL TIMES, Aug. 10, 1998, at 18.

<sup>54</sup> John Willcock, *Stars Mine Gold From Rock of Wages*, THE INDEPENDENT, June 16, 1999, at 2.

<sup>55</sup> *Whispers Asset Securitization Report*, ASSET SECURITIZATION REPORT, July 31, 2006.

suffered a reduction in its own credit rating because of the market disruption caused by digital piracy.<sup>56</sup> Finally, single artist music royalty securitizations similar to the Bowie Bonds proved difficult to replicate because, unlike David Bowie, most musicians do not own the publishing rights or record masters to their catalog of songs.<sup>57</sup> In 2003, UCC Capital Corporation<sup>58</sup> attempted to circumvent this problem by structuring a music royalty securitization intended to provide financing to a music publishing collective in which artists had pledged their copyright royalties, however the deal faced significant resistance from the music industry and ultimately failed to come to fruition.<sup>59</sup>

Though only a handful of music royalty securitizations have been completed since 1997, the Bowie Bonds catalyzed interest in securitizing other forms of intellectual property assets, including trademarks and patents. The following chart represents the number of IP securitization transactions completed between 1997 and 2002.<sup>60</sup>

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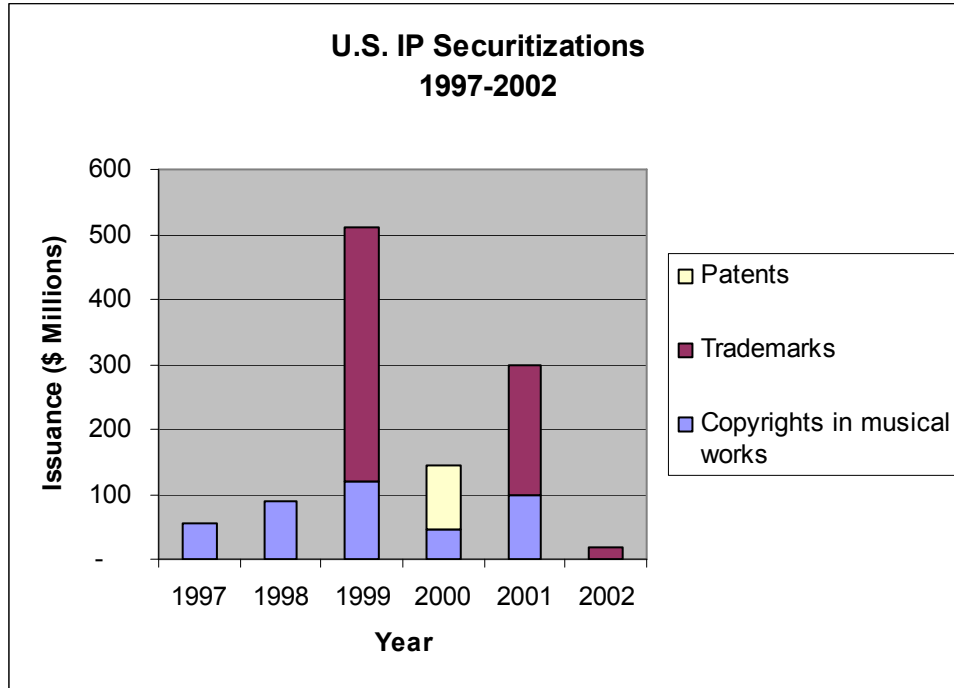
<sup>56</sup> Nic Fleming, *Bowie: Man Whose Bonds Fell to Earth*, THE DAILY TELEGRAPH, March 25, 2004, at 11.

<sup>57</sup> Kerr, *supra* note 50, at 393-94.

<sup>58</sup> As a matter of disclosure, the author of this article was employed as a Senior Associate at UCC Capital Corporation from 2002-2005, and was involved in work related to this transaction. The author of this article was also an employee of UCC Capital when it completed the Athlete's Foot and BCBG/MaxAzria securitizations.

<sup>59</sup> Several securitization transactions have been completed in the film industry that are similar to IP securitizations but will not be discussed at length in this article. Those transactions, known as "slate deals" involve the securitization of a portfolio of future films to be released by a particular studio in order to finance production costs. Dreamworks, Paramount Motion Pictures and Focus Features have all completed slate deals within the past five years. Moreover, in November 2005, Marvel Entertainment completed a hybrid slate deal / copyright securitization when it issued \$525 million in bonds backed both by its copyrights in comic book characters, including Captain America and the Incredible Hulk, and by its expected income from future feature length films based on those characters. Yael Bizouati, *From Donuts to Dollars*, INVESTMENT DEALER'S DIGEST, May 7, 2007 available at [http://www.iddmagazine.com/idd/fierce\\_finance.cfm?id=13786&issueDate=current](http://www.iddmagazine.com/idd/fierce_finance.cfm?id=13786&issueDate=current).

<sup>60</sup> This chart was prepared by UCC Capital Corporation



During this time period, issuers evolved from single artists in the music industry to companies with valuable trademarks or patents who generated IP royalty income by licensing out the use of their intellectual property to third parties. In 1999, for example, Bill Blass completed a \$25 million securitization of its trademarks and associated third party licensing contracts to facilitate a leveraged buy out. Similarly, in 2002 the branded apparel company Candies issued \$20 million in bonds backed by its trademark and third party licensing agreements to obtain acquisition financing.

IP securitizations also expanded to include transactions backed by patent portfolios; however, these deals met with mixed success because of the high degree of risk associated with such transactions.<sup>61</sup> Though one patent may represent multiple exploitation opportunities, both technology and pharmaceutical patents are particularly vulnerable to the threat of becoming obsolete within a very short time period and to facing obstacles in the supply and distribution chains that are necessary to exploit them. Patents also face a high risk of being invalidated, even after they have been issued by the Patent and

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<sup>61</sup> Ariel Glasner, *Financing Intellectual Property*, INTELLECTUAL ASSET MANAGEMENT MAGAZINE, Aug./Sept. 2005, at 24.

Trademark Office, because of regulatory controls surrounding patents,<sup>62</sup> and because the current “first to invent” system makes it hard for patent owners to predict if their patent will be ruled invalid when another party files a patent application on the same invention.<sup>63</sup> Some of these risks were highlighted in 2000, when Yale University securitized its licensing royalties, generated through an exclusive license to Bristol-Myers Squibb, from the FDA-approved HIV/AIDS drug Zerit. Royalty Pharma structured the transaction and obtained a single A rating from Standard & Poor’s for the bonds issued by the newly-created SPV, BioPharma Royalty Trust (“BioPharma”). The rating was calculated based on an assessment of Zerit’s sales forecasts and both Yale’s and Bristol-Myers’ high credit rating, and led investors to conclude that that the SPV would meet its debt payments. As a result of the sale of its assets into the SPV, Yale received \$100 million in cash to construct a new medical facility.<sup>64</sup>

By late 2002, the A-rated bonds issued by BioPharma had defaulted as sales of Zerit plummeted. The immediate cause of the default can be traced to Bristol-Myers’ decision to sell off its inventory of Zerit to wholesalers at a discount; however, the transaction was actually structurally unsound from the outset. Only a single patent was transferred into the SPV, instead of a portfolio of patents that could better mitigate risk through diversity. Royalty Pharma also overvalued the Zerit patent by approximately \$400 million because it elected to complete its own valuation of the patent instead of hiring an independent, and impartial, third-party valuation firm.<sup>65</sup>

Though aggregate data reflecting the total number of transactions completed since 2002 do not exist, in the five years since the BioPharma deal defaulted, the IP securitization market has gone through two significant periods. Between 2003 and 2005 only a few IP securitizations were issued; however, the transactions that were completed were notable for their success. In July 2003, Royalty Pharma structured a securitization that recovered from the mistakes made in the Zerit transaction, by creating a SPV that owned a portfolio of 13

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<sup>62</sup> Yael Bizouati, *From Donuts to Dollars*, INVESTMENT DEALER’S DIGEST, May 7, 2007 available at [http://www.iddmagazine.com/idd/fierce\\_finance.cfm?id=13786&issueDate=current](http://www.iddmagazine.com/idd/fierce_finance.cfm?id=13786&issueDate=current).

<sup>63</sup> Matthew P. Becker, *The Patent Reform Act of 2007: How it May Impact Patent Rights*, LAW.COM, May 4, 2007 available at <http://www.law.com/jsp/article.jsp?id=1178096682581>.

<sup>64</sup> Glasner, *supra* note 61, at 24.

<sup>65</sup> *Id.* at 24.

biopharmaceutical patents and the rights to future patents.<sup>66</sup> The SPV, Royalty Pharma Finance Trust, issued \$225 million in AAA rated bonds, which was credit enhanced by MBIA and had a maturing schedule of seven years.<sup>67</sup> Also in 2003, the Athlete's Foot franchise system completed an approximately \$20 million securitization of its trademarks and associated royalty contracts to facilitate a management buyout.<sup>68</sup> In December 2004, the branded apparel company BCBG/MaxAzria issued \$50 million in bonds backed by its trademark and third party licensing agreements to recapitalize and refinance a working capital line.<sup>69</sup>

Since 2005, the IP securitization market has literally taken off to new heights. In January 2005, Quiznos issued a \$250 million securitizations backed by its trademarks and associated franchise royalties.<sup>70</sup> Eighteen months later, Dunkin' Brands issued \$1.7 billion in bonds backed by its trademarks and associated royalties from its franchising operations.<sup>71</sup> The deal was credit enhanced by Ambac and, therefore, received a triple-A rating from Standard & Poor's.<sup>72</sup> Funds raised through the securitization were used by the originator to repay debt incurred by Dunkin' Brands' leveraged buy out in March, 2006.<sup>73</sup>

Though patent securitizations have yet to be completed with regularity, most likely because of the perceived risk associated with patents, IP securitizations of trademarks continue to expand dramatically. Soon after Dunkin' Brands completed its securitization, Sears Holdings Corp. ("Sears") issued \$1.8 billion in securities backed by its trademarks in its Kenmore, Craftsman and DieHard ("KCD") brand names.<sup>74</sup> Sears's securitization is unique because the royalty income generated by the KCD brand names is not from preexisting licensing agreements between Sears and third parties for the use of its

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<sup>66</sup> MOODY'S INVESTORS SERVICES, RATING ACTION: ROYALTY PHARMA FINANCE TRUST – WAREHOUSE FACILITY, July 30, 2003 available at <http://www.royaltypharma.com/media/pr/2003/Moody-07302003.pdf>.

<sup>67</sup> *Id.*

<sup>68</sup> Glasner, *supra* note 61, at 24.

<sup>69</sup> *Id.* at 23.

<sup>70</sup> Bizouati, *supra* note 62.

<sup>71</sup> *Id.*

<sup>72</sup> *Id.*

<sup>73</sup> *Id.*

<sup>74</sup> Robert Berner, *The New Alchemy at Sears*, BUSINESS WEEK ONLINE, April 16 2007 available at [http://www.businessweek.com/magazine/content/07\\_16/b4030071.htm?campaign\\_id=yahoo](http://www.businessweek.com/magazine/content/07_16/b4030071.htm?campaign_id=yahoo).

trademarks, but from Sears itself.<sup>75</sup> To accomplish the transaction, Sears sold the KCD trademarks into a SPV called KCD IP, which then began charging Sears royalty fees to exploit the KCD brands. The royalty payments into the SPV were then used to pay off the bonds, which were issued by KCD IP and purchased by Sears's off-shore insurance subsidiary.<sup>76</sup> This structure means that the payments from the securitization all net out to zero, which is unusual, because most IP securitizations are designed to raise funds that can be put towards acquisitions or debt restructuring. According to Sears, however, the underlying rationale for the transaction was to offset any potential losses incurred by its insurance subsidiary and not to raise additional capital.<sup>77</sup>

In April, 2007 IHOP completed a more "conventional" trademark securitization when it issued \$200 million in bonds backed by its trademarks and associated franchise royalties.<sup>78</sup> That same month, Domino's Pizza also completed a \$1.85 billion securitization backed by its trademarks and franchise royalties to refinance its debt and buy back stock.<sup>79</sup>

#### IV. WHAT MAKES IP SECURITIZATIONS UNIQUE

##### A. THE BROADER PICTURE

IP securitizations are different from conventional asset-based securitizations in part because of the different nature of the legal property regimes that govern IP assets. Most significantly, IP assets do not have the "tangible presence" associated with fixed assets.<sup>80</sup> Whereas property rights for tangible goods are rooted in the well-established state common law of personal property, property rights for IP assets are governed by a set of laws in the federal copyright, trademark and patent regimes, and those laws continue to change.<sup>81</sup> The basis for property rights in copyright is *authorship* in a given work, and the purpose of the rights is to give the owner the "exclusive right to copy, distribute copies, make derivative works, and take other defined actions with respect to that expression."<sup>82</sup> Patent property rights on the other hand, are grounded in

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<sup>75</sup> *Id.*

<sup>76</sup> *Id.*

<sup>77</sup> *Id.*

<sup>78</sup> Bizouati, *supra* note 62.

<sup>79</sup> *Id.*; *Domino's Pizza Declares \$13.50 Per Share Special Dividend*, FOOD AND BEVERAGE CLOSE-UP, April 18, 2007.

<sup>80</sup> Nimmer, *supra* note 28, at 292.

<sup>81</sup> *Id.* at 292.

<sup>82</sup> *Id.* at 292.

standards of *inventiveness and utility*, and provide for the “right to prevent anyone else from making, using, selling or offering to sell the patented invention.”<sup>83</sup> Lastly, trademark rights prevent others from using any “distinctive images, marks, or terms that identify the products or service of a company” in order to protect against consumer confusion or dilution of the mark.<sup>84</sup>

The property regimes that govern different IP rights in turn affect the character of the security interest that is ultimately taken in those assets and the nature of the asset transfer into the SPV. For instance, the security interest in a patent covers the owner’s “adversarial” right to preclude others from making, using or selling the invention but it does not extend to the “affirmative” right to make, use or sell an invention.<sup>85</sup> Moreover, while security interests in fixed assets focus on ownership rights to the actual property; security interests in intellectual property target the use and control of information related to the underlying IP assets.<sup>86</sup> Thus, a secured creditor who lends against a computer program or master copy of a record is only taking a security interest in a fixed asset, unless it explicitly provides for a security interest in the copyright associated with the program or song. Similarly, an interest in a patented invention does not automatically convey rights in the underlying patent.<sup>87</sup> In order to be secured, those rights must be conveyed separately from the fixed assets.

In certain, limited respects, intellectual property assets share features associated with fixed goods because the IP asset could not exist without a corresponding tangible asset. For example, the copyright to a motion picture characterizes the film as a work of authorship and grants the copyright owner the “exclusive right to make and distribute copies of the work, to publicly perform it,” or to make derivative works.<sup>88</sup> These rights are obviously intangible because it is impossible to physically possess them. Nevertheless, the Copyright Act requires works of authorship to be “fixed” in a tangible medium that can be “perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device” in order for a work of authorship to fall under its auspices.

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<sup>83</sup> *Id.* at 292.

<sup>84</sup> *Id.* at 292-93.

<sup>85</sup> *Id.* at 293.

<sup>86</sup> *Id.* at 293.

<sup>87</sup> *Id.* at 293-94.

<sup>88</sup> 17 U.S.C. § 106 (1976); Nimmer, *supra* note 28, at 294.

The motion picture is indeed captured in such a tangible medium, in the form of celluloid film or on a CD.<sup>89</sup>

Though copyright law does not protect the hardcopy of the CD of a motion picture, it bears a relationship to physical possession of the work by protecting the exclusive right to make and distribute copies of it.<sup>90</sup> This issue was underscored by the First Circuit in *Forward v. Thorogood*, when the court considered whether the owner of a band's unpublished recorded demo tapes held the copyright to those tapes.<sup>91</sup> The court affirmed the lower court's decision and ruled that the owner of the tapes did not hold the copyright to the tapes.<sup>92</sup> More importantly, the court held that the creator of the work, and not the owner of the physical embodiment of it, is the presumptive owner of the copyright unless the creator demonstrates a specific intent to transfer ownership of the copyright.<sup>93</sup> In so holding, the Court dismissed the *Pushman presumption*, which was eliminated by the Copyright Act of 1976, but which applied to works created before then. The *Pushman presumption* inferred intent to transfer ownership of a copyright from the "unconditional sale of a manuscript or painting" to a new owner, and therefore would have granted the copyright to the owner of the cassette tapes.<sup>94</sup>

Unlike copyrights, in the case of patents no similar relationship exists between the property rights that are provided through patent law and the physical embodiment of the invention. Though patent law requires a description of the invention and its utility, to obtain a patent the invention does not need to be physically present in order for the patent owner to assert rights against third parties, and third parties can infringe against a patent even without having prior knowledge of the patent owner's invention.<sup>95</sup>

Trademarks represent yet another manifestation of the relationship between the underlying intellectual property and a physical work. The application for a trademark requires, pursuant to section 1 of the Lanham Act, submission of a drawing of the mark and the date of the applicant's first use of

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<sup>89</sup> 17 U.S.C. § 102(a); Nimmer, *supra* note 28, at 294-95.

<sup>90</sup> 17 U.S.C. § 202; Nimmer, *supra* note 28, at 295.

<sup>91</sup> *Forward v. Thorogood*, 985 F.2d 604, 604-05 (1st Cir. 1993).

<sup>92</sup> *Id.* at 605.

<sup>93</sup> *Id.* at 605 (citing *Cnty. for Creative Non-Violence v. Reid*, 490 U.S. 730, 737 (1989)).

<sup>94</sup> *Id.* at 605 (citing *M. NIMMER & D. NIMMER, 1 NIMMER ON COPYRIGHT § 2.10[A](2)(a)*, at 2-149 (1992)).

<sup>95</sup> 35 U.S.C. § 271 (1952); Nimmer, *supra* note 28, at 295.

it.<sup>96</sup> As this provision and other portions of the Lanham Act suggest, the whole basis for a trademark is that it is identified with particular commercial goods and serves as a tangible mark to distinguish brands or manufacturers of the goods for the consumer's benefit.<sup>97</sup>

Understanding the relationship between the property rights conveyed to intellectual property assets, and physical possession of the underlying tangible asset is important to an appreciation of structured finance transactions backed by IP assets. If the originator company is seeking a loan backed by goods in its possession that have no intellectual property rights associated with them, then state personal property law applies, and it will not normally be hindered from transferring the assets into an SPV, and then granting a security interest in them.<sup>98</sup>

Suppose however that a lender provides funding to a company that lawfully owns a copy of a computer program, and as part of a securitization transaction the lender decides to take a security interest in the copy of that program.<sup>99</sup> As discussed above, possession of the computer program does not convey the intellectual property rights associated with it, and the debtor/originator therefore has no right to copy and distribute multiple copies of the program because doing so would violate federal copyright law.<sup>100</sup> The doctrine of "first sale" provides the debtor with a limited right to distribute the particular copy that it owns, but that right can be restricted by the purchase agreement between it and the company that sold it the software program.<sup>101</sup> If

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<sup>96</sup> 15 U.S.C. § 1051(a)(2) (1946).

<sup>97</sup> 15 U.S.C. §§ 1051-1054, 1058.

<sup>98</sup> "Goods" are defined in Article 9 of the Uniform Commercial Code ("UCC") for the purpose of security interests as "all things that are movable when a security interest attaches. The term includes (i) fixtures, (ii) standing timber that is to be cut and removed under a conveyance or contract for sale, (iii) the unborn young of animals, (iv) crops grown, growing, or to be grown, even if the crops are produced on trees, vines, or bushes, and (v) manufactured homes." U.C.C. § 9-102(a)(44) (2001).

<sup>99</sup> The definition of "goods" in the UCC also includes a "computer program embedded in goods and any supporting information provided in connection with a transaction relating to the program if (i) the program is associated with the goods in such a manner that it customarily is considered part of the goods, or (ii) by becoming the owner of the goods, a person acquires a right to use the program in connection with the goods. The term does not include a computer program embedded in goods that consist solely of the medium in which the program is embedded." U.C.C. § 9-102(a) (44). In other words, a software program on a computer as described in this example is considered a "general intangible" and not a "good" by the UCC because of the software's independent status.

<sup>100</sup> 17 U.S.C. § 106.

<sup>101</sup> *Id.* § 109(a); Nimmer, *supra* note 28, at 299.

that right is restricted, then the debtor may be unable to effect a true sale of the asset into the SPV, or grant a security interest in the copy of the software program in its possession.<sup>102</sup>

Alternatively, suppose the debtor company is the designer of the computer software program, and therefore chooses to borrow against the copyright and patent which it owns in its software. The copyright protects the debtor's right to make and distribute copies of the program, while the patent in the software protects the debtor's right to preclude competitors from using the patented process in the program. A security interest in the copyright and patent would not extend to the hard copies of the program in the debtor's possession, unless the security agreement separately provided for such an interest.

## B. CONFLICTING LEGAL REGIMES

Lending against intellectual property assets through a securitization is particularly complex because of the potential for conflict between the federal law regimes that govern IP assets and the state secured credit law manifested in Article 9 of the UCC.<sup>103</sup> The type of intellectual property at issue determines the degree of conflict that occurs between the two legal regimes. However, the investor and ratings agency must always address a common set of issues in assessing the validity of an IP securitization, which are outlined as follows and which will be discussed in greater depth below.

First, the secured creditor must determine who owns the intellectual property, which can be difficult because of federal statutes governing registration of intellectual property and transfers of ownership.<sup>104</sup> Ascertaining this fact is critical to resolving whether a true sale of the assets into the SPV has indeed taken place. The secured creditor must also ensure that it takes the proper steps to perfect its security interest in the assets of the SPV, which vary depending on the intellectual property asset at issue.<sup>105</sup>

Lastly, the purchaser of the securities must search the relevant filing systems (state and/or federal filing systems, depending on the IP asset), in order to ascertain its priority position as a secured creditor, and determine whether other lenders have pre-existing claims against the SPV's intellectual property assets.<sup>106</sup> The secured creditor's position may also be affected if the debtor has

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<sup>102</sup> Nimmer, *supra* note 28, at 299.

<sup>103</sup> *Id.* at 296.

<sup>104</sup> *Id.* at 296-97.

<sup>105</sup> *Id.* at 297.

<sup>106</sup> *Id.* at 297.

entered into a licensing agreement with a third party to exploit or copy products that include the underlying IP in which the creditor has taken a security interest.<sup>107</sup> Such licensing agreements are common, for example, in the software industry, and generally allow the licensee to make and distribute a certain number of copies for its business use. These agreements also generally take priority over the secured creditor, and therefore a creditor taking a security interest in the debtor's copyright would have collateral consisting of the "exclusive" right to make and distribute copies except for the number of copies that the licensee has been allowed to make.<sup>108</sup>

## V. TRANSFERRING IP ASSETS INTO THE SPV

### A. TRANSFERRING OWNERSHIP OF COPYRIGHT ASSETS

A transfer of ownership in the underlying intellectual property assets takes place first, when the assets are sold down into the SPV by the originator, and second, in the event of default by the SPV when the bondholder takes ownership of the asset.<sup>109</sup> The transfer of ownership in a copyright, however, represents a particularly arcane and complex part of copyright law, and all parties to a securitization must proceed cautiously.

In assessing the feasibility of the asset transfer, the parties must first trace ownership of the copyright and determine that the originator holds valid title to the copyright assets involved in the securitization.<sup>110</sup> Valid title for the purposes of a securitization means that the originator properly owns the copyright; that the work has not entered into the public domain; and, that the originator can transfer ownership of the copyright into the SPV without risking a termination of the transfer by the author or the author's statutory surviving heirs. To ascertain the originator's disposition with respect to each of the copyright assets subject to the securitization, the legal due diligence team must be attentive to when the work

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<sup>107</sup> *Id.* at 297.

<sup>108</sup> *Id.* at 297-98.

<sup>109</sup> Jay C. Klear, *Applicability of Private Equity Fund Structure in the Furtherance of Intellectual Property Securitizations*, 2002 COLUM. BUS. L. REV. 796, 805 (2002).

<sup>110</sup> The originator is generally the assignee of the copyright author; though, in certain instances (which are discussed in depth in the section focusing on attaching an interest to the collateral), the originator may be an exclusive licensee or, in rare circumstances, a non-exclusive licensee of the copyright owner.

was created; how and by whom it was authored; and whether the work complied with the statutory formalities in obtaining the copyright.<sup>111</sup>

Depending on when the copyrighted work was created determines which copyright regime applies to the statute. Though older copyrights are less likely to be generating royalties sufficient for a securitization transaction, it is possible that some of the copyrighted assets subject to the securitization will have been created prior to January 1, 1978, the effective date of the current copyright regime. If that is the case, the 1909 Copyright Act applies. Pursuant to that Act, the initial term of a copyright is 28 years and it can be renewed for an additional 28 years. The Sonny Bono Copyright Term Extension Act (“CTEA”) of 1998, however, provided for an extension of the life of copyrighted works published under the 1909 Act. Specifically, section 304(a) provides that a copyright in its first term on January 1, 1978 is extended for an additional duration of 67 years (i.e., 95 years from the date of publication).<sup>112</sup> Furthermore, a copyright already in its renewal term by January 1, 1978 was extended by the Sonny Bono Copyright Term Extension Act (“CTEA”) to a date of 95 years from publication.<sup>113</sup> The CTEA also extended the duration of copyrights created after the Copyright Act of 1976 became effective, to a period of the author’s life plus 70 years.<sup>114</sup>

While these rules may seem “relatively” simple in determining when a copyrighted work enters the public domain, a layer of complication is added by the statutory provisions governing copyright ownership. For instance, in the case of a work made jointly by multiple authors, the duration of the copyright is for 70 years beyond the death of the last surviving author.<sup>115</sup> In the case of a work made for hire, which is defined in section 101 of the Copyright Act, ownership of the copyright rests with the employer,<sup>116</sup> and the duration of the copyright is for 95 years from publication, or 120 years from creation, whichever expires first.<sup>117</sup> Once the copyright term has expired, the work enters into the public domain.

Tracing the title of the copyrighted work through public records represents the third layer of complexity in determining ownership. Works created under the

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<sup>111</sup> As discussed below, under the present Copyright Act, compliance with the statutory formalities is voluntary. Prior regimes required compliance with the formalities in order to obtain a valid copyright.

<sup>112</sup> 17 U.S.C. § 304(a)(1)(B) (1998).

<sup>113</sup> *Id.* § 304(b).

<sup>114</sup> *Id.* § 302(a).

<sup>115</sup> *Id.* § 302(b).

<sup>116</sup> *Id.* §201(b).

<sup>117</sup> *Id.* § 302(c).

1909 Act were required to be properly registered and deposited with the Library of Congress in order to obtain a valid copyright and keep the work from entering into the public domain. Those rules were gradually relaxed, however, until passage of the Berne Convention Act of 1988, which made compliance with copyright formalities such as registration, deposit and notice, permissive instead of compulsory.<sup>118</sup> While certain incentives continue to exist for copyright owners to comply with providing notice of the copyright, registering it and depositing it with the Library of Congress, the fact that a copyright owner is not required to provide a clear public record of the creation and ownership in its copyright, necessarily makes the due diligence process more complicated for assessing ownership interests.

Once the originator's ownership of the copyright has been established, the federal copyright regime continues to complicate the determination as to whether the copyrights can lawfully be transferred into the SPV or into the hands of the bondholder in the event of default, without facing a risk that the transfer will be terminated by the author or the author's statutory heirs. For example, section 304(c) provides that for a copyright in its first or renewal term on January 1, 1978, and transferred by a copyright owner (e.g., a songwriter) to another party (e.g., to a music publisher or film producer), the transfer can be terminated under a variety of circumstances.<sup>119</sup> If the transfer was originally executed by someone other than the author, then it may be terminated by any of the surviving grantors.<sup>120</sup> If the author herself transferred the copyright, then she retains the right to terminate it, or if she has passed away then her heirs, as defined in sections 304(c)(1) and (2) of the Copyright Act, can terminate the transfer, so long as the transfer was not made through the author's will.<sup>121</sup> Sections 304(c)(3) and 304(c)(4)(A) provide for the period of time during which the transfer of ownership can be terminated and how to effect the termination. Specifically, a transfer of ownership can be terminated at any time during a period of five years beginning at the end of 56 years from the date the copyright was originally secured.<sup>122</sup> (Thus, a 1975 copyright that was transferred to another owner that same year, can be terminated beginning in 2031 until 2036.)

Section 203 of the Copyright Act of 1976 governs the transfer of copyrights created after January 1, 1978. An author who executed a transfer of ownership may terminate that grant at any time during a period of five years beginning at

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<sup>118</sup> *Id.* § § 401-12.

<sup>119</sup> *Id.* § 304(c).

<sup>120</sup> *Id.* § 304(c)(1).

<sup>121</sup> *Id.* § § 304(c)(1)-(2).

<sup>122</sup> *Id.* § 304(c)(3).

the end of 35 years from the date of execution of the grant, or 35 years from the date of publication of the work if the ownership transfer included the right of publication.<sup>123</sup> (Thus, a copyright transferred in 1980 can be terminated in 2015). If the author who granted the initial ownership transfer is dead, then his surviving statutory heirs can effect the termination.<sup>124</sup> These provisions are all important to consider because a secured creditor cannot take a security interest in a copyright if, during the term of the securitization, the author or the author's statutory heirs can terminate the transfer of ownership in the copyright to the originator, thereby invalidating the asset's sale to the SPV.

Besides having to wade through the nuances of the statutory provisions concerning the termination of a transfer of ownership by the work's original author or her statutory heirs, the Berne Convention Act made recordation of a transfer of copyright ownership permissive, but not compulsory.<sup>125</sup> This means that parties to a securitization may not be able to verify that the originator actually holds the rights to the copyrighted works.

All of the complexities inherent to establishment of ownership and the duration of a copyright, and to the termination of transfers of copyright, raise serious questions as to the feasibility of transferring copyright assets into an SPV. Based on a thorough analysis of the provisions of the current copyright regime, selling copyright assets to the SPV is feasible, but comprehensive due diligence is required that will no doubt add significant costs to the completion of an IP securitization.

## B. TRANSFERRING OWNERSHIP OF PATENT ASSETS

Unlike copyrights, the transfer of ownership of a patent is more straightforward. Section 261 of the Patent Act provides explicitly that:

*An assignment, grant or conveyance shall be void as against any subsequent purchaser or mortgagee for a valuable consideration, without notice, unless it is recorded in the Patent and Trademark Office within three months from its date or prior to the date of such subsequent purchase or mortgage.*<sup>126</sup>

This provision makes clear that any transfer of ownership in a patent must be recorded with the Patent Office. Unlike the 1976 Copyright Act, the patent statutory regime does not make any separate provisions allowing for the inventor

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<sup>123</sup> *Id.* § 203(a)(1), (3).

<sup>124</sup> *Id.* § 203(a)(2).

<sup>125</sup> *Id.* § 205(a).

<sup>126</sup> 35 U.S.C. § 261; Ronald L. Leibow & Marlene M. Moffitt, *Transfer of Intellectual Property Rights in Bankruptcy*, 877 PLI/COMM 137, 192 (2005).

or the inventor's statutory heirs to terminate a transfer of ownership. Nevertheless, the Patent Act is not without its own potential pitfalls. In *In re Cybernetic Services, Inc.*, the Ninth Circuit Court of Appeals noted that recordation with the Patent Office is not required when a license is granted to a third party to exploit a patent for a particular purpose.<sup>127</sup> As discussed previously, however, such a license may affect the secured creditor's priority position with respect to the intellectual property collateral, which means that the existence of such licenses should be ascertained prior to completing the securitization.<sup>128</sup> Without being able to simply check Patent Office records, tracing the existence of patent licensing agreements, particularly for patents owned previously by an entity or individual different from the originator, will no doubt add to the costs of due diligence required to ensure that the securitization of a patent portfolio can move forward.

Pursuant to section 261, in order to complete the sale of the patent assets into the SPV the sale must be recorded within three months of the transaction.<sup>129</sup> The Ninth Circuit clarified the definitions of "assignments," "grants" and "conveyances," all of which involve specific instances of the transfer of title in a patent.<sup>130</sup> For example, an assignment transfers specific rights associated with the patent or title in the patent itself,<sup>131</sup> whereas a grant is defined as transferring an ownership interest in a patent within a "specific geographic area."<sup>132</sup> The definition of a conveyance is less certain, but generally refers to transfer of ownership in a patent from the present owner to another.<sup>133</sup> Though it is unclear whether the sale of the patent into the SPV qualifies specifically as an assignment or conveyance, there is no doubt that this form of transfer is covered by section 261 of the Patent Act, and that therefore the sale must be recorded with the Patent Office.<sup>134</sup>

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<sup>127</sup> *In re Cybernetic Sevs., Inc.*, 252 F.3d 1039, 1052 (9th Cir. 2001).

<sup>128</sup> Nimmer, *supra* note 28, at 297.

<sup>129</sup> 35 U.S.C. § 261.

<sup>130</sup> *In re Cybernetic Sevs., Inc.*, 252 F.3d at 1049-50.

<sup>131</sup> *Id.* at 1049-50 (referring to *Oliver v. Rumford Chem. Works*, 109 U.S. 75, 82-83 (1883), and *Waterman v. Mackenzie*, 138 U.S. 252, 255 (1891)).

<sup>132</sup> *Id.* at 1050 (referring to *Moore v. Marsh*, 74 U.S. 515, 521 (1868)).

<sup>133</sup> *Id.* at 1050 (referring to *Abendroth v. Town of Greenwich*, 29 Conn. 356 (1860)).

<sup>134</sup> *See id.* at 1053.

### C. TRANSFERRING OWNERSHIP OF TRADEMARK ASSETS

Tracing title and transferring ownership in trademarks is only slightly more complicated than that just described for patent assets. Like the Patent Act, the assignment of a trademark must be effected in writing.<sup>135</sup> Unlike the Patent Act, the federal trademark regime known as the Lanham Act does not make registration compulsory,<sup>136</sup> but registration of a trademark on the Principal Register, which is provided for in section 1 of the Act, leads to a presumption of ownership, validity and exclusivity in the trademark.<sup>137</sup> Thus, an originator can effectively protect its ownership interest in its trademarks from third parties by ensuring that all of its marks are registered at the time of the securitization transaction and by verifying that no other entity had previously registered the marks being used as collateral. When transferring the ownership interests in a trademark for the purposes of a securitization, the transfer must also be recorded with the U.S. Patent and Trademark Office.<sup>138</sup> Doing so will ensure that a subsequent bona fide purchaser of the trademark will not be able to assert a claim and will also reinforce the credibility of the true-sale opinion behind the transfer.<sup>139</sup>

The transfer of trademark assets into the SPV is only complicated by the Lanham Act's proscription against the sale of trademarks without the goodwill associated with them.<sup>140</sup> Any assignment that transfers a mark without goodwill is considered an "assignment in gross" and leads to the involuntary abandonment of the marks by the transferor.<sup>141</sup> The primary rationale behind this rule is that trademarks have traditionally been considered to exist "only as symbols of goodwill," and are protected solely because of the information they convey to consumers regarding the product they are purchasing.<sup>142</sup> Courts have also

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<sup>135</sup> 15 U.S.C. § 1060(a)(3) (1946).

<sup>136</sup> Christina Bohannon & Thomas F. Cotter, *When the State Steals Ideas: Is the Abrogation of State Sovereign Immunity From Federal Infringement Claims Constitutional in Light of Seminole Tribe?*, 67 *FORDHAM L. REV.* 1435, 1444-45 (1999).

<sup>137</sup> 15 U.S.C. § 1051(a); Karen A. Butcher & Brian S. Kelly, *Acquiring or Selling the Privately Held Company: Intellectual Property Issues*, 1546 *PLIC/CORP* 727, 737 (2006).

<sup>138</sup> *Id.* at 738.

<sup>139</sup> *See id.* at 738.

<sup>140</sup> 15 U.S.C. § 1060(a)(1).

<sup>141</sup> Ronald L. Panitch, *Trademarks, Copyrights, and Unfair Competition for the General Practitioner and the Corporate Counsel*, SLO82 *ALI-ABA* 1, 13 (2006).

<sup>142</sup> Butcher & Kelly, *supra* note 137, at 781.

explained that the rule ensures that the quality of the product a trademark symbolizes will not be diminished when transferred to an assignee.<sup>143</sup>

When first applied, a trademark assignment only passed the assignment in gross rule if a simultaneous transfer of “tangible business assets” took place with the mark transfer.<sup>144</sup> That standard relaxed significantly over time, however.<sup>145</sup> By the 1980s, the bankruptcy court in *Matter of Roman Cleanser Co.* suggested that the test is “not one of quantity, but of quality, looking at the nature and the relationship of the transferred assets to that type of business.”<sup>146</sup> Ten years later, most courts applied a broad standard to the transfer of goodwill that essentially allowed for trademark alienability by allowing assignments to be valid so long as “sufficient continuity” or “substantial similarity” existed between the marked goods produced by the assignor and those produced by the assignee.<sup>147</sup> Today, the standard for avoiding an assignment in gross transfer of trademarks is ambiguous, as is the definition of what constitutes “goodwill,” but nevertheless the test is an easy one to pass in the context of a securitization transaction.<sup>148</sup>

A structured finance transaction inherently meets this standard in at least two ways: First, the limited purpose of the SPV means that from an operational perspective the trademarks continue to be used in the originator’s business in the same way that they were previously. Second, the sale of the trademarks to the SPV meets the rule against assignments in gross because the sale includes the licensing contracts associated with the trademarks that generate the receivables intended to pay the bondholders. The sale of the marks to the SPV is therefore accompanied by tangible assets, which meets the narrower version of the rule that was applied before enactment of the Lanham Act.<sup>149</sup>

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<sup>143</sup> *Id.* at 783.

<sup>144</sup> *Id.* at 789.

<sup>145</sup> *Id.* at 789-90.

<sup>146</sup> *Matter of Roman Cleanser Co.*, 43 B.R. 940, 947 (E.D. Mich. 1984).

<sup>147</sup> *Butcher & Kelly*, *supra* note 137, at 792.

<sup>148</sup> *See id.* at 788-811.

<sup>149</sup> *Id.* at 789.

## VI. ATTACHING AND PERFECTING A SECURITY INTEREST IN IP ASSETS

### A. ATTACHING AN INTEREST IN THE COLLATERAL PURSUANT TO ARTICLE 9

Once the originator has successfully sold the IP assets into the SPV to the satisfaction of the ratings agency and securities investor, the parties must establish that the investor can first, attach, and then, perfect, a valid security interest in the IP assets owned by the SPV. Article 9 of the UCC governs the granting of security interests in personal property.<sup>150</sup> Though the plain text of the statute does not explicitly cover intellectual property assets, it is a well-established rule that intellectual property assets are governed by it.<sup>151</sup> The comment to section 9-102(a)(42) unambiguously states that intellectual property assets fall within the definition of “general intangibles:”

[This] is the residual category of personal property, including things in action.... Examples are various categories of *intellectual property* ... As used in the definition ... “things in action” includes rights that arise under a license of intellectual property, including the right to exploit the intellectual property without liability for infringement.<sup>152</sup>

Despite this seemingly clear rule, some confusion remains regarding how certain rights associated with intellectual property assets are treated by the UCC, particularly those rights arising under a non-exclusive intellectual property license.<sup>153</sup> For instance, suppose a patent owner grants a non-exclusive license to a manufacturer to exploit the patent for a particular purpose, and that a lender to the manufacturer then wants to take a security interest in the licensee’s rights under the license.<sup>154</sup> The Official Comment to section 9-102(a)(42) appears to include this scenario within the scope of the statute because it describes the IP assets that qualify for general intangibles as the “right to exploit the intellectual property without liability for infringement.”<sup>155</sup> However, Article 9 cannot apply if

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<sup>150</sup> Nimmer, *supra* note 28, at 308-09.

<sup>151</sup> *Id.* at 309.

<sup>152</sup> U.C.C § 9-102 cmt. 5d (2001).

<sup>153</sup> Nimmer, *supra* note 28, at 309.

<sup>154</sup> Because a patent only gives the owner the right to exclude others from exploiting the patented technology, a patent license does not give the licensee the right to “make, use, or sell” the licensed work but actually represents an agreement by the licensor not to sue the licensee for infringement so long as the licensee acts within the bounds of the parties’ agreement. Nimmer, *supra* note 28, at 310.

personal property rights are not at stake and, according to intellectual property case law, most non-exclusive licenses for the exploitation of copyrights, trademarks or patents, do not grant the licensee any property rights in the licensed work, unless the license grants the licensee ownership in a copy of the work.<sup>156</sup>

Exclusive licenses, by contrast, are generally considered to transfer property rights to the licensee in the licensed work.<sup>157</sup> Under patent law, for example, a non-exclusive licensee does not have standing to sue third parties for infringement, but an exclusive licensee may do so.<sup>158</sup> Similar to patents, exclusive trademark licenses also may provide the licensee with standing to sue third parties for infringement.<sup>159</sup> The Copyright Act also defines an “exclusive license” as one form of a transfer of copyright ownership.<sup>160</sup>

One way of reconciling this dilemma is to allow attachment of security interests to intellectual property assets pursuant to Article 9 only when the originator has ownership rights in the IP, whether those ownership rights come in the form of actual title to the copyrights, trademarks or patents, and thus allow the originator to act as a licensor; or whether they come in the form of an exclusive license and thus allow the originator standing to sue third parties for infringement. Accordingly, creditors would, in most cases, be unable to obtain a secured interest in a non-exclusive licensee’s rights, except to the extent that the licensing arrangement gave the licensee ownership over copies of the licensed work. Alternatively, a secured creditor could obtain an interest in the promise that the licensor has made to the non-exclusive licensee not to sue for infringement, which does have some value, though limited, without taking a security interest in the underlying intellectual property asset.<sup>161</sup> The law is unsettled as to the “correct” course of action. However, no matter which path a lender chooses to pursue, it is well advised to communicate with the licensor in order to verify the rights to which the debtor licensee is entitled.<sup>162</sup>

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<sup>155</sup> *Id.* at 310-11.

<sup>156</sup> *Id.* at 310-11.

<sup>157</sup> *Id.* at 310.

<sup>158</sup> *Id.* at 310, note 59 (referring to *Kepner-Tregoe, Inc. v. Vroom*, 51 U.S.P.Q.2d 1771, 1776 (2d Cir. 1999); *Rite-Hite Corp. v. Kelley Co., Inc.*, 56 F.3d 1538, 1553-54 (Fed. Cir. 1995)).

<sup>159</sup> Juli W. Marshall, *Litigation Issues in Intellectual Property Licensing*, 763 PLI/PAT 231, 246-47 (2003).

<sup>160</sup> Nimmer, *supra* note 28, at 310, note 59 (referring to 17 U.S.C. § 101).

<sup>161</sup> *Id.* at 311.

<sup>162</sup> *Id.* at 311.

## B. PERFECTING AN INTEREST IN COPYRIGHTS

As discussed briefly above, two of the overriding issues that affect IP securitizations from a secured creditor's point of view concern perfecting a lien on the IP assets, and ensuring that the assets are not encumbered by any prior liens. In a conventional asset-backed securitization, the secured creditor perfects its interest in the asset by filing in the state filing system pursuant to Article 9.<sup>163</sup> The general rule of thumb is that the first to file has priority over other secured creditors.<sup>164</sup> In certain instances, perfection can also be effected in conventional assets through possession or control of the asset, or by filing in real property records if the secured asset constitutes real property or a fixture, as defined in U.C.C. § 9-102(a).<sup>165</sup>

These concerns are also relatively simple to resolve with respect to personal property because state secured credit law regime offers a "debtor-based format" for filing financing statements.<sup>166</sup> According to this format, ownership in goods is tracked by reference to the individual or corporate owner.<sup>167</sup> Article 9 also allows for the filing of liens on all the debtor's assets through a single agreement filed under the debtor's name.<sup>168</sup> Moreover, section 9-515 provides for a "self-clearing" system that invalidates security interests if the secured creditor fails to renew them after five years, which eases the burden on a prospective creditor to search for pre-existing security interests.<sup>169</sup>

In contrast to the debtor-based format for filing security interests in conventional personal property, the federal property regimes that govern intellectual property assets are characterized as "item-based systems."<sup>170</sup> This format is driven by one of the fundamental policy concerns of intellectual property law that individuals should reap economic incentives for producing particular creative works and exploiting them.<sup>171</sup> From a practical perspective, the federal item-based system that applies to IP assets is more complicated than

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<sup>163</sup> LYNN M. LOPUCKI & ELIZABETH WARREN, *SECURED CREDIT: A SYSTEMS APPROACH* 276-77 (Aspen Publishers 5th ed. 2006).

<sup>164</sup> *Id.* at 276.

<sup>165</sup> *Id.* at 320-50.

<sup>166</sup> Nimmer, *supra* note 28, at 301.

<sup>167</sup> *Id.* at 302.

<sup>168</sup> *Id.* at 301.

<sup>169</sup> LOPUCKI & WARREN, *supra* note 163, at 371-72.

<sup>170</sup> Nimmer, *supra* note 28, at 301.

<sup>171</sup> *Id.* at 301.

Article 9's registration system, because it requires recordation of the security interest in each particular copyright, trademark or patent instead of filing one agreement for all the respective security interests taken in the debtor's assets.<sup>172</sup> Because of federal preemption doctrine, secured creditors may therefore have to perfect their security interests in intellectual property assets through the more cumbersome federal law regime instead of through the state law filing system. The federal IP regimes are also more burdensome on prospective creditors because they do not have the self-clearing system that state filing systems have. As the filing systems are computerized, however, the lack of a self-clearing system becomes less of a problem. Lastly, in contrast to certain kinds of conventional asset-backed securitizations, the perfection of a security interest in IP assets cannot be achieved through possession of the assets because they are considered "intangible."

Existing case law, though limited, suggests that perfection of a security interest in copyrights must be completed by filing with the Copyright Office and not with the state law filing system.<sup>173</sup> Specifically, in *In re Peregrine Entertainment, Ltd.*, a California District Court held that security interests in copyrights must be filed with the Copyright Office.<sup>174</sup>

The court based its decision on section 101 of the Copyright Act, which defined the transfer of copyright ownership as including the "hypothecation" of the copyright.<sup>175</sup> According to the court, "hypothecation" of a copyright covers the granting of a security interest and, therefore, the federal copyright regime preempts state law.<sup>176</sup> The court acknowledged that perfecting security interests through the Copyright Office may indeed be less convenient than filing under the UCC because registration in the Copyright Office is by title, whereas UCC filings are indexed by owner.<sup>177</sup> In other words, a security interest in a catalog of copyrights requires a filing for each individual copyright, and for a filing to be made whenever the catalog adds or removes a work.<sup>178</sup> By contrast, a UCC-1 filing covers the assets of a particular type owned by the debtor, and remains good even if the asset class is periodically updated.<sup>179</sup> Besides making it more

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<sup>172</sup> *Id.* at 301.

<sup>173</sup> *Id.* at 280-81.

<sup>174</sup> *In re Peregrine Entm't, Ltd.*, 116 B.R. 194, 203 (C.D. Cal. 1990).

<sup>175</sup> *Id.* at 205.

<sup>176</sup> *Id.* at 205.

<sup>177</sup> *Id.* at 203.

<sup>178</sup> *Id.* at 203.

<sup>179</sup> *Id.* at 203.

costly and time consuming for a secured creditor to actually file and perfect its interest in the copyright assets, this rule also makes it burdensome for the secured creditor to search through the copyright registry to determine whether any encumbrances already exist on the originator's assets.

Since the California District Court's decision in *Peregrine*, the Ninth Circuit has reached several decisions that have had the combined effect of narrowing the scope of the *Peregrine* decision while leaving prospective secured creditors only more confused as to how to perfect their interests in copyright assets.<sup>180</sup> In *Broadcast Music, Inc. v. Hirsch*, the circuit court considered whether the appellants were required to record an assignment of a songwriter's copyright royalty income with the Copyright Office.<sup>181</sup> The assignment had been made to satisfy debt that the songwriter owed the appellants.<sup>182</sup> Broadcast Music, Inc. ("BMI") sought a resolution to this question in order to determine whether the appellants had properly perfected their interest in the songwriter's royalty income ahead of tax liens that had been subsequently attached and perfected by the IRS against the songwriter.<sup>183</sup> The court held that the underlying purpose of perfecting a security interest in a copyright through recordation with the Copyright Office is to place prospective creditors or purchasers of the copyright on notice of the existence of the encumbrance.<sup>184</sup> According to the *BMI* decision, this rationale does not apply when an outright assignment of royalties is made and, therefore, the appellants did not have to perfect their interest in the royalty assignment through recordation.<sup>185</sup>

Despite the court's attempt to distinguish an outright assignment of royalties from the nature of a security interest, its holding is extraordinarily difficult to apply consistently because any assignment of copyright receivables can be described as an "outright assignment" without effecting the nature of the assignment.<sup>186</sup> Thus, some courts could define the assignment of royalties for the purposes of taking a security interest as an "outright assignment" that does not need to be recorded in the Copyright Office, while other courts could find that

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<sup>180</sup> Klear, *supra* note 109, at 808-11.

<sup>181</sup> *Broad. Music, Inc. v. Hirsch (BMI)*, 104 F.3d 1163, 1165 (9th Cir. 1997).

<sup>182</sup> *Id.* at 1165.

<sup>183</sup> If the appellants were required to record the assignment and failed to do so, then the IRS would have had priority over the appellants to the songwriter's royalty income, in order to satisfy the deficient tax payments. *Id.* at 1165.

<sup>184</sup> *Id.* at 1166.

<sup>185</sup> *Id.* at 1166.

<sup>186</sup> LOPUCKI & WARREN, *supra* note 163, at 284.

such an assignment is not “outright” and therefore needs to be recorded with the Copyright Office. Under the *BMI* decision, both courts are correct.<sup>187</sup> Notwithstanding the Ninth Circuit’s holding in *BMI*, a bondholder that is party to a copyright securitization is still best off perfecting its interest in the copyright assets by filing with the Copyright Office, particularly because the securitization involves a sale of the copyright assets into the SPV and not just an assignment of the royalties.

The Ninth Circuit further narrowed the scope of the *Peregrine* holding in *In re World Auxiliary Power Co.*, 303 F.3d 1120 (9th Cir. 2002).<sup>188</sup> In that decision, the court held that a security interest in an unregistered copyright should not be recorded in the Copyright Office because it would fail to give “constructive notice” to other secured creditors of the lien and would not, therefore, preserve a creditor’s priority position.<sup>189</sup> Not only does this holding complicate the method of perfecting an interest in a copyright, but it also leaves important questions unanswered. For instance, the court did not consider circumstances whereby a secured creditor perfects an interest in an unregistered copyright through the state filing system, and subsequently the copyright is registered with the Copyright Office. If the creditor fails to then register its interest with the Copyright Office, does its interest remain perfected? <sup>190</sup> Ultimately, questions such as this one, as well as the myriad issues raised by *Peregrine* and its progeny increase the cost of securitizing copyright assets because the case holdings engender a significant level of uncertainty as to how and when a security interest in a copyright is actually perfected.

### C. PERFECTING AN INTEREST IN PATENTS AND TRADEMARKS

Fortunately, the confusion that pervades the securitization of copyright assets has not extended to the obtaining of a security interest in trademarks or patents. Though the Patent and Trademark Office does accept security agreements for filings, several courts have held that the federal property law regimes for trademarks and patents do not preempt the UCC with respect to

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<sup>187</sup> *Id.* at 284.

<sup>188</sup> Klear, *supra* note 109, at 810.

<sup>189</sup> *In re World Auxiliary Power*, 303 F.3d 1120, 1126 (9th Cir. 2002).

<sup>190</sup> U.C.C § 9-315 may provide some guidance to this question. That provision holds that when collateral changes form, a secured creditor is required to re-file a financing statement if the appropriate means of perfection have changed. Thus, in order to maintain its perfected interest in the newly registered copyright, the secured creditor would be required to file with the Copyright Office. U.C.C § 9-315(d).

filing.<sup>191</sup> The courts based their decisions on the fact that the Lanham Act only provides for “assignments” of trademarks and does not provide for the granting of a security interest in a trademark.<sup>192</sup> Similarly, with respect to patents, the Patent Act does not refer to “hypothecations” or security interests and therefore does not apply.<sup>193</sup>

#### D. CALCULATING THE VALUE OF THE SECURED IP ASSETS

To successfully perfect the bondholders’ security interest, and to enable the rating agency to assign a credit rating to the SPV, the value of the IP assets owned by the SPV must be calculated. The valuation is completed through a quantitative and qualitative assessment of the royalty flow generated by the underlying IP assets. Typically, the starting point for a valuation is an examination and analysis of the historical data.<sup>194</sup> Because a securitization requires a predictable future stream of income, the assets subject to collateral must demonstrate a history of steady revenues upon which the prediction can be made.<sup>195</sup> In practical terms, this means that the IP assets at issue should have a royalty payment history dating back at least three to five years.<sup>196</sup>

In addition to the longevity of the royalty stream, the stability of the income is important to consider. For example, an artist with a “one-hit wonder” from their tenth album may indeed be able to demonstrate a history of royalties, but would not meet the requirement for earning a *predictable* set of cash flows, unless the revenues generated by the one hit were severely discounted in the valuation process.<sup>197</sup>

#### E. CALCULATING THE VALUE OF TRADEMARK ROYALTIES

As is evidenced by the superior number and success of intellectual property securitizations backed by trademarks, this class of IP has the greatest tendency to generate a predictable set of future cash flows because of the nature

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<sup>191</sup> LOPUCKI & WARREN, *supra* note 163, at 284-86.

<sup>192</sup> Matter of Roman Cleanser Co., 43 B.R. at 944; *In re* TR-3 Indus., 41 B.R. 128, 131 (C.D. Cal. 1984).

<sup>193</sup> *In re* Cybernetic Sevs., Inc., 252 F.3d at 1053; *In re* Pasteurized Eggs Corp., 296 B.R. 283, 292 (D.N.H. 2003).

<sup>194</sup> John M. Gabala, Jr., “*Intellectual Alchemy*”: *Securitization of Intellectual Property as an Innovative Form of Alternative Financing*, 3 J. MARSHALL REV. INTELL. PROP. L. 307, 323-25 (2004).

<sup>195</sup> *Id.* at 323-25.

<sup>196</sup> Glasner, *supra* note 61, at 23.

<sup>197</sup> Gabala, *supra* note 194, at 323-25.

of the licensing contracts that companies with core assets in trademarks, such as franchisors and branded apparel companies, enter into for the use of their trademarks. Typically, a franchisor will enter into agreements with its franchisees that permit the franchisees the use of the franchisor's trademarks in exchange for an upfront franchise fee plus a percentage of ongoing sales thereafter. So long as a franchisor seeking to secure financing through an IP securitization can demonstrate that the contracts it has entered into with its multiple franchisees provide a predictable set of future royalty streams, and that the diversity of franchisees offsets the risk of any one franchisee going out of business, the securitization will likely be feasible.

Similarly, a branded apparel company operates by entering into licensing agreements with third party manufacturers who pay a percentage of sales to the apparel company in exchange for the use of the licensor's trademark. Often, a predictable royalty stream is realized because the licensing contracts provide for minimum guarantees that the third party manufacturers owe the licensor annually.

While calculating the royalties derived from trademark licensing agreements is relatively straightforward, trademark holders can exploit their trademarks through other means, most notably through the distribution and sale of their own products. Franchisors may also generate additional revenues by entering into rebate agreements with suppliers, such as soft drink beverage companies, to supply products to all of their franchisees. The originator's exploitation of its trademarks through these other means must be accounted for in determining the value of the trademarks being sold into the SPV, though doing so is often a difficult and inherently subjective task.

Rebate agreements typically vary from year to year, and thus need to be discounted heavily so that only the future predictable income stream from these agreements is taken into account in setting the price of the bond issuance. Determining how the trademark holder's own product sales reflect the overall value of the trademarks can be even more difficult.<sup>198</sup> This calculation is often achieved by discounting the average of historic and future expected net product sales, by a factor that is determined based on variables such as the industry in which the originator operates, the nature of the product that is being sold, and whether brand differentiation is important to generating product sales.

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<sup>198</sup> "Goodwill," which is defined as the measure of a "business's reputation, patronage, and other intangible assets that are considered when appraising the business", (BLACK'S LAW DICTIONARY (8th ed. 2004), and which often is reflected as an asset on a company's financial statements, is not specific enough to satisfy this determination.

## F. CALCULATING THE VALUE OF COPYRIGHT ROYALTIES

Determining that a copyright owner is generating a predictable royalty stream is more difficult than with trademark royalties. To understand why, it is first important to describe how copyrights in musical works generate royalties, since they have been the principal target of securitization transactions. A songwriter who has penned a song and owns the copyright to it retains exclusive rights of ownership pursuant to section 106 of the Copyright Act.<sup>199</sup> Those rights include the right to reproduction of the song; the right to alter or prepare other versions of the song; the right to distribute it; and the right to publicly perform and present the song to others.<sup>200</sup> Section 115 of the Copyright Act gives the songwriter exclusive control over sale of the “first release” of the performance of the song, after which anyone has the right to record it so long as they pay compulsory royalties to the copyright owner.<sup>201</sup>

Obviously, however, the songwriter’s copyright is worth nothing unless the song that she penned is actually performed. To achieve this goal, most songwriters, unlike David Bowie, assign ownership of their copyright in the song to a music publishing company that is better equipped to promote their song.<sup>202</sup> In exchange, the writer is awarded the “writer’s share” of royalties generated by the copyright, which usually amounts to 50 percent.<sup>203</sup> Securitizing a writer’s share of the royalties is not feasible because the writer no longer owns the copyrights in the songs and therefore does not have them available for the transfer into the SPV.

Once the copyright (and the song) is in the music publisher’s hands, the publisher will produce a demo of the song and, if successful, will get a performing artist to sing it and put it on her album.<sup>204</sup> From this point forward, the song begins to generate royalties through several different channels. Each time a copy of the song is sold, be it on a CD or through a digital music store such as iTunes, the copyright holder is entitled to a “mechanical royalty” which is set at a statutory rate, and which is collected by the Harry Fox Agency, who then distributes it to the music publisher.<sup>205</sup>

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<sup>199</sup> John E. Murdock III & John M. Rolfe, Jr., *On the Record: How Music Connects with Law*, 15-AUG BUS. L. TODAY 17, 17 (2006).

<sup>200</sup> *Id.* at 17.

<sup>201</sup> *Id.* at 17-18.

<sup>202</sup> *Id.* at 18.

<sup>203</sup> *Id.* at 18.

<sup>204</sup> *Id.* at 18.

<sup>205</sup> *Id.* at 18.

Whenever a song is performed, whether live or on radio, the copyright owner of a song is also entitled to a “performance royalty.” Performance royalties are collected by performing rights organizations (“PROs”), who collect the royalties and then calculate each copyright owner’s pro-rata share of the royalties.<sup>206</sup> The PROs also set the royalty rate owed for the performance of a particular song, independently of one another, based in part on the total value of their members’ songs to the broadcasting outlet. (Thus, a radio station might pay a higher royalty rate compared to other PROs for playing songs that ASCAP is collecting if ASCAP has a greater concentration of the artists that the radio station desires.) Finally, a publishing company grants “synchronization licenses” to licensees who want to use the song in motion pictures television programs and commercials.<sup>207</sup>

To complete a valuation of the royalties generated by a catalog of copyright assets, therefore, the valuator must account for three different royalty streams for each copyright and then discount those streams by the amount owed to the writer as part of the writer’s share, and must also deduct the promotion fees and expenses that the publishing company incurred in order to market the song. To generate a *predictable* cash stream, the catalog of musical copyrights must either include a diverse portfolio of songwriters, or a prolific songwriter who has demonstrated a history of stable cash flows that are not subject to the volatile whims of the public’s changing tastes. Ultimately, because of the many factors involved in completing a valuation of a catalog of copyright assets, an investor may find that the actual value of the collateral for purposes of the securitization is much lower than originally anticipated.

## G. CALCULATING THE VALUE OF PATENT ROYALTIES

Like copyrights, valuing a portfolio of patent assets also presents significant complications. Unlike copyrights or trademarks, however, a patent holder does not have the right to affirmatively exploit its invention, only to prevent anyone else from “making, using, selling or offering to sell the patented invention.”<sup>208</sup> Thus, patent holders generate value from their patents through two means: First, by entering into licensing agreements that allow the licensees to exploit the patent for a particular use without facing an infringement suit by

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<sup>206</sup> *Id.* at 18.

<sup>207</sup> *Id.* at 18.

<sup>208</sup> Nimmer, *supra* note 28, at 292.

the patent holder<sup>209</sup>; and, second, by filing suits against parties whom the patent holder believes are infringing on its patents.

The difficulty in valuing both exclusive and non-exclusive licensing agreements was exemplified by the Zerit drug securitization, because it demonstrated how vulnerable patent licensing royalties are to disruptive market forces and advances in technology. Though patent licensing arrangements often include a minimum guaranteed payment, that payment only kicks in once a product employing the patented technology has been successfully commercialized.<sup>210</sup> For this reason, and because of the high degree of risk associated with such ventures, securitization of start-up technology companies' patent portfolios is virtually impossible. If the licensee fails to meet the minimum guarantee, the license can either be terminated or the licensee may be required to make up the difference between the paid royalties and the guaranteed minimum.

The Supreme Court's recent decision in *MedImmune, Inc. v. Genentech, Inc.* poses another hurdle to calculating a patent owner's future licensing royalty income.<sup>211</sup> In that case, the Court held that a licensee may challenge the validity of a patent despite the common-law rule that a "party to a contract cannot at one and the same time challenge its validity and continue to reap its benefits."<sup>212</sup> Though the long-term impact of the *Genentech*<sup>213</sup> decision has yet to be assessed, in the short term the Court's holding increases the already high risk that patent owners will have their patents declared invalid and, thus, makes calculating a predictable future income stream more difficult.

Another means of generating income from patents is for the owner to file suit against infringing parties. This practice has become increasingly popular as patent holding companies (derogatorily known as "patent trolls") have formed with the express purpose of buying patents and then asserting them against infringing companies. Though some such companies have contemplated the possibility of securitizing their patents in order to obtain funds up front that could support their ongoing litigation costs, the income derived from patent infringement suits is inherently volatile, and calculating a predictable future income stream based on this business model is virtually impossible.

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<sup>209</sup> *Id.* at 310-11.

<sup>210</sup> Beth Lynn Maxwell, *Overview of Licensing Technology From Universities*, 762 PLI/PAT 507, 528 (2003).

<sup>211</sup> *MedImmune, Inc. v. Genentech, Inc.*, 127 S.Ct. 764, 777 (2007).

<sup>212</sup> *Id.* at 776.

<sup>213</sup> *Id.*

The problems associated with obtaining patent licensing royalties suggest that though patent holders may have a sufficient level of royalty income to enter into a securitization, accurately calculating the value of these royalty streams will present a significant obstacle to completing the securitization.

## VII. THE FUTURE OF IP SECURITIZATIONS

### A. LEGISLATIVE REFORM PROPOSALS

A thorough analysis of the issues associated with intellectual property asset securitizations underscores the significant legal hurdles that must be overcome in order for these transactions to gain traction in the modern business economy. One way of overcoming these hurdles is to enact legislative reforms that would address some of the specific issues discussed in this article. Given the increasing frequency and size of trademark securitizations, legislative reform does not appear necessary to overcome the relatively low barriers to completing trademark securitizations, particularly as institutional knowledge spreads regarding how to complete these transactions. For copyrights, however, legislation reinstating compliance with statutory formalities such as registration and deposit of copyrighted works, or legislation requiring recordation of security interests taken in copyrights with the state UCC filing system, would make tracing ownership rights in copyrights significantly easier and would lower the costs of the due diligence process.

For patents, the proposed Patent Reform Act of 2007 (“PRA”) represents at least a partial step forward towards mitigating some of the risks associated with patent ownership and, consequently, easing the way towards more securitizations of patent portfolios.<sup>214</sup> The PRA proposes two major changes. First, if passed, the legislation would implement a “first to file” system to replace the current “first to invent” system.<sup>215</sup> Not only would this change bring the United States in line with the rest of the world, but it would provide patent owners with greater certainty of the validity of their patents, which would

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<sup>214</sup> The PRA was passed as H.R. 1908 by the House of Representatives in September 2007 and was marked up and reported as S. 1145 by the Senate Committee on the Judiciary in January 2008. Nevertheless, the full Senate failed to vote on the bill and the legislation was tabled.

<sup>215</sup> Matthew P. Becker, *The Patent Reform Act of 2007: How it May Impact Patent Rights*, LAW.COM, May 4, 2007 available at <http://www.law.com/jsp/article.jsp?id=1178096682581>; David R. Bailey, *United States: Key Changes in Patent Reform Act of 2007*, MONDAQ BUSINESS BRIEFING, May 3, 2007.

ultimately increase the creditworthiness of the patents in securitization transactions.<sup>216</sup>

The second significant change proposed by the PRA would be to allow for anyone to seek cancellation of an issued patent within 12 months of the issuance date, through a new “streamlined” post-grant proceeding.<sup>217</sup> It would also allow any party to seek invalidation of an issued patent at any time if the party can establish a “substantial reason” that the continuing existence of the patent “causes or is likely to cause that party significant harm.”<sup>218</sup> Though this proposal may create uncertainty about the validity of a patent, it likely would have little or no effect on the ability to complete IP securitizations. Most of the uncertainty created by this provision would only exist in the first 12 months of the patent’s existence and, therefore, would not have a dramatic impact on the types of patents that are suitable for a securitization, i.e., patents that have already been in existence for a period of three to five years. Moreover, the provision precludes parties who unsuccessfully brought claims under the new post-grant proceeding from bringing claims on the same grounds in subsequent litigation, which would help prevent a dramatic rise in the number of suits that patent owners may expect seeking to invalidate their patents as a result of passage of the PRA.

In addition to the reforms already on the table, patent securitizations could potentially gain more traction if further legislation aimed at decreasing the risk of patent invalidation were enacted. This may prove more difficult with respect to pharmaceutical patents than with technology patents, given the existence of strict regulatory controls that provide wide latitude to the FDA to recall patents.<sup>219</sup> Legislation requiring patent licensing agreements to be recorded with the Patent Office would also help the market for securitizations of patent portfolios because it would improve secured creditors’ ability to trace the originator’s ownership rights.

## B. IP SECURITIZATIONS AND THEIR EFFECT ON INNOVATION

Besides legislative reform, IP securitizations will proliferate the more the investor community and potential issuers are educated regarding the positive impact that such securitizations can have on technological innovation and on improving the way companies with core assets in intellectual property operate. The recent worldwide credit crisis means that sources of financing for completing

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<sup>216</sup> See Becker, *supra* note 215.

<sup>217</sup> *Id.*

<sup>218</sup> *Id.*

<sup>219</sup> Bizouati, *supra* note 62.

IP securitizations are no longer available in the short term. Nevertheless, once liquidity is restored to the marketplace, investors will be attracted to IP securitizations that are structured properly and that reflect a comprehensive and conservative approach to valuing the underlying assets.

As discussed above, patent securitizations do not represent a means of financing the litigious activities of patent holding companies, which generally are considered to stymie innovation by increasing the costs of owning patents. Moreover, the fact that a securitization requires the sale of the IP assets into the SPV does not mean that the originator loses control of its intellectual property. On the contrary, by selling its portfolio of patents into an SPV, technology and pharmaceutical companies will be encouraged to focus on new ways of exploiting their patents to generate additional licensing royalty fees. In the unlikely event of foreclosure on the assets by the bondholder (such an occurrence has yet to take place in an IP securitization), the bondholder will have an incentive to transfer the patent portfolio to a manager who can continue to find new ways to exploit the patents through licensing opportunities, so that the bond debt has the greatest probability of being paid off.

Similar to the effect of IP securitization on technological innovation, increasing securitizations of trademarks will ensure that companies change their operating philosophy to focus on building brand recognition instead of trying to reduce manufacturing costs. The recent proliferation and success of brand holding companies such as Cherokee and Iconix Brand Group as well as multi-concept franchisors such as Dunkin' Brands and Yum! Brands, are a testament to this approach. Most of these companies have already completed securitizations of their trademark assets or foresee doing so on the horizon. By focusing on exploiting their trademarks, all of these entities have opened up new licensing opportunities and thus are able to maximize the value of their intellectual property assets.

Lastly, though the investor community may be skeptical of the positive possibilities of copyright asset securitizations given the history of the Bowie Bonds and its progeny, securitizing the copyrights of multiple artists has the potential to spark significant change in the way the music world operates, and could also spawn transformations in other parts of the entertainment industry. Specifically, copyright securitizations represent a means for publishing companies to leverage their copyrights in musical works, as well as for entities in other parts of the entertainment business to leverage their intellectual property assets, including the copyrights to films, comic book characters, or plays. The proceeds from these securitizations can then be used to restructure existing debt or to finance new projects, and ultimately help ensure the originating company's success.