

Securitisation of intellectual property assets in the US market

*William J. Kramer and Chirag B. Patel
Marshall, Gerstein & Borun, Chicago, IL*

Corporations that have little or no tangible assets are able to obtain significant funding without selling a significant portion of the ownership of the corporation. How? One way is to offer security interests in intangible assets such as intellectual property in the form of patents, trademarks and copyrights.

While intellectual property is not a tangible asset in a traditional sense, it is an asset and there are ways to obtain funding by collateralising intellectual property. Asset securitisation, the practice of converting an asset or a stream of cash flows into marketable securities, is well known in the finance industry but is relatively new to the world of intellectual property. Asset securitisation started in early 1980s by securitisation of auto-loan receivables and credit card receivables and has grown to cover a very wide range of assets, from auto loans to pub revenues. Moving into the future, securing funding using intellectual property will be even more important as the focus of corporations continues to move toward developing intellectual property.

There are many reasons to use intellectual property as collateral with three primary reasons being:

1. intellectual property is an untapped source of collateral;
2. intellectual property securitisation offers a quick return on research and development; and
3. intellectual property securitisation captures additional value.

An untapped source of collateral

A number of studies have shown that intellectual property plays an increasingly important part in the US and world economy. For example, value of intangible assets as a percentage of the market capitalisation of US companies increased from 20% in 1978 to 73% in 1998, demonstrating that the ratio of value of intangible assets to the value of tangible assets of US companies has steadily increased over this period (*Intangibles Management, Measurement and Reporting*, Baruch Lev, Brookings Institute, 2001). Accordingly, if a company relies only on tangible assets for asset backed financing, its choices are restricted to a much smaller asset base compared to one using its intangible assets, such as intellectual property in the form of patents, trademarks, etc., for asset backed financing. By being able to offer such additional assets as security, corporations are able to tap additional sources of funding, often at better rates.

A quick return on research and development

The ability to turn research and development innovations into assets such as patents, trademarks and copyrights that can be offered as security to lenders is key to industries that have few tangible assets. According to a Brody-Berman Associates survey, in 1998, leading technology companies spent on average US\$3.8 million in research and

development ('R&D') costs per patent granted. Securitisation based on patent portfolios provides these companies an alternate way to finance such R&D costs. By being able to quickly realise a return on R&D dollars by securitising revenue streams, firms can quickly fund further R&D.

Capture additional value

Valuing intellectual property is notoriously difficult. By securitising intellectual property, a minimum known value can be attributed to these assets that may be greater than previously thought. In this day of questionable accounting, corporations that already include on financial statements significant value for intellectual property assets may have additional support for the valuation by demonstrating that the secondary market is willing to assign a similar value to the intellectual property.

Methods to use intellectual property as borrowing collateral

Generally, for a class of an asset to be securitised, such an asset should have following qualities:

1. stability and certainty of cash flows;
2. availability of large diversified portfolios; and
3. abundance of historical statistical information.

While the majority of asset securitisation completed today uses as collateral only tangible assets that meet these basic criteria, in last few years there has been increasing interest in securitisation of intangible assets, specifically intellectual property such as patents, copyrights and trademarks. There are several methods to securitise intellectual property.

Intellectual property royalty financing

Intellectual property royalty financing in its simplest form is a non-recourse debt financing, where a licensor of intellectual property can take the future cash flow expected from a licence agreement and receive a cash payment up front, representing the present value of the future cash flow. Intellectual property royalty financing allows the owner of the intellectual property to keep an equity interest in the intellectual property, and thus, the owner of such property can still profit from the upside value of such an asset beyond the security interest on the debt. As intellectual property royalty financing is non-recourse to the borrower, it does not affect the risk profile of the borrower, and the borrower is not restricted by covenants found in traditional bank loans or other corporate securities.

In 1997, there was about US\$380 million of known intellectual property royalty financing, all based on music and film royalties. In 2000, the volume had increased to about US\$840 million, including royalties from music, film and pharmaceutical patent licences.

The most well-known example of intellectual property royalty based financing is the issuance of 10 year Bowie bonds in 1997 based on future royalties on the back catalogues of pop musician David Bowie. This transaction generated US\$55 million for David Bowie and was rated single A by all major bond rating agencies. A variation of

intellectual property royalty financing is the patent-backed securitisation where cash flows generated by licensing agreements on patents are securitised using the underlying patents as the collateral. As an example, Yale University borrowed approximately US\$100 million based on 70% royalty interest in the patent and licensing agreement between Yale and Bristol-Myers Squibb company based on certain US patent applications.

To structure an intellectual property royalty financing transaction, it may be necessary to create a special purpose vehicle ('SPV') or special purpose entities ('SPE') similar to those used in creating other asset-backed securities. Such SPEs function as separate legal entities with separate independent directors and the SPE collects and administers the cash flows generated by the intellectual property. A variation of such a structure involves creating an intellectual property holding company as a subsidiary of the parent company where the intellectual property holding company licenses the intellectual property to third party licensees. The SPE borrows money from lenders with the licence rights as collateral and uses the licence royalties from licensees to pay the interest to the lenders.

Loans collateralised by title to intellectual property

Another type of securitisation involves loans collateralised by title to intellectual property. Here, a company holding a number of patents in its portfolio can borrow a percentage of the value of the portfolio using the patent portfolio as collateral. This method of financing is particularly useful for a small inventor who has valuable patents but who is cash strapped to develop products and markets based on such patents. Such loans allow the inventor to generate cash without giving equity. An example of such a patent backed loan transaction is a US\$17 million financing raised by

GIK Worldwide, a small technology company with valuable patents in technology for delivering high-speed broadcast quality video conferencing. Instead of tapping the venture capital market, GIK borrowed from Pitney Bowes Capital and collateralised the debt by its patents assessed at US\$57 million.

Valuing intellectual property is a controversial issue. A lender offering a loan backed by intellectual property can use one of a number of valuation methods such as the market value method, the cost method, the discounted cash flow ('DCF') method, the technology risk reward unit method (TRRU™) (valuing a patent right as call option on the claimed technology and using a model similar to the Black-Scholes option pricing model) to value the patent portfolio of the borrowing company. A lender may use more than one of these methods to value a patent portfolio, or obtain a valuation from more than one outside vendor, to get a most probable value for the patent portfolio. For example, independent sources such as 'PI-x' (See <http://www.PI-x.com>), 'M-cam', (See <http://www.m-cam.com>) may be used to provide valuation.

Similarly, an investor interested in lending based on such patent portfolio should also take extra steps to reduce the risks attached to patent rights, such as invalidity risk, valuation risk, etc. These risks may require, for example, getting a competent opinion from an appropriate intellectual property law firm regarding the validity of a patent or patents within a portfolio, as well as obtaining infringement enforcement insurance or

defense cost reimbursement insurance. A number of insurance companies, including Swiss Re and Intellectual Property Insurance Services Corporation offer various levels of insurance products that may be suitable to reduce risks related to patent rights.

Sale/licence-back transactions

An intellectual property sale/licence-back transaction is a means to monetise intellectual property assets that currently have a high market value. The structure of intellectual property sale/licence-back transactions are similar to real estate sale/licence-back transactions in that a parent company with an intellectual property portfolio transfers the intellectual property assets and rights to an SPE, generally wholly owned by the parent company, and where the SPE licenses the intellectual property assets back to the parent company. The SPE may get a loan from a financial institution using titles to the intellectual property received from the parent company as a collateral and use the loan proceeds to reimburse the parent company.

In the past six months, due to the increased uncertainty in the financial markets, lenders investing in SPEs providing instruments based on patent sale/licence-back structures are increasingly requiring patent portfolios to have royalty streams in place through licensing agreements rather than loaning against a portfolio without regard to royalty streams. Moreover, lenders are also closely looking at the credit rating of the licensees, to insure that they have credit rating of at least investment grade or above. Companies may increase the success of such transactions by buying insurance to protect the patent rights.

A parent company not only receives the value of the intellectual property transferred to the SPE at the outset of the transaction, but it also enjoys a tax deduction for the amount of annual licence payments. Depending on the structure of the sale/licence-back transaction, the parent company may retain full use of the intellectual property for the duration of the negotiated licence period. Alternately, it may also negotiate an option for eventual repurchase of the intellectual property back from the SPE at the termination of the licence period.

There are several organisations that specialise in assisting technology companies in setting up and running a sale/licence-back programme for intellectual property. One example of such an organisation is TAEUS consulting company, which is near closing a US\$500 MM, 10 year sale/licence-back deal for a technology firm, based on a pool of 900 patents. Due to the high transactional and processing cost involved with setting up intellectual property sale/licence-back programs, such transactions are generally feasible only for large organisations with, for example, a large number of patents in its portfolio of IP.

Legal issues

From the perspective of the intellectual property owner, in order to instill confidence in potential investor, great care must be taken to ensure that the securitisation is properly executed. An investor looking into investing in any SPE used for intellectual property securitisation must be assured that the transfer of intellectual property rights to the SPE are perfected or are legally enforceable.

A first step often includes properly recording the specific transfer rights. According to the Copyright Act of 1976, any transfer of copyright ownership or other documents pertaining to a copyright may be recorded in the Copyright Office. Similarly, in the case of patents, the Patent Act requires that an assignment, grant or conveyance of patent must be recorded in the Patent and Trademark Office within three months of such transfer.

A second step may be for an investor in intellectual property based security to review the financial conditions and credit quality of the licensees as the licensees payments to the SPE will be used to pay the SPE's debt. The licensee's credit quality is important because section 365(e) of the Bankruptcy Code does not allow a licensor, in this case the SPE, to enforce any forfeiture clauses against a licensee who has filed bankruptcy petition. This results in placing the payments to the investor in direct jeopardy.

Potential pitfalls

Sensing the potential for a lucrative market in the field of intellectual property securitisation, a number of companies providing such services have filed applications for business method patents with the Patent and Trademark Office. For example, David Pullman, the creator of Bowie bonds, has filed an application on several key aspects of the Pullman bond securitisation process and TEQ development has patent applications on file. Moreover, there are at least two patents issued by the Patent and Trademark Office (patent numbers 6,018,714 and 6,330,527), which claim various methods designed to reduce the risk, or to enhance the creditworthiness of intellectual property.

The use of Special Purpose Vehicles or Entities has come under heightened scrutiny after the alleged misuse of SPEs at such high profile corporate failures such as Enron and Adelphia. Accordingly, corporations may need to weigh the negative implication of creating an SPE even for the limited purpose of securitising intellectual property.

Creating assets out of innovations is not an inexpensive proposition. Fees for obtaining assets such as patents and trademarks (along with the 'lost' employee time in assisting the process) can be significant. However, intellectual property has many useful purposes such as creating a royalty revenue stream, providing bolstered financial statements and providing a shield against aggressive competitors in addition to being a source of collateral, such that the benefits of an intellectual property programme outweigh the costs.

Conclusion

While the introduction of Bowie Bonds in 1997 promised a new era in the securitisation of intellectual property assets, the growth of the industry has been slow. Much of the activity in this field, with the few exceptions noted above, has been confined to the music industry.

However, based on the reduction of traditional tangible assets and the increased importance of intangible assets on balance sheets of major corporations, along with the increase in the number of tools available to reduce the risks associated with financing

based on intellectual property (such as various intellectual property insurance products), this may be an opportune time for growth of intellectual property securitisation industry.