COLLATERALIZATION OF INTELLECTUAL PROPERTY
BOWIE BONDS AND THE COLLATERAL OF THE FUTURE

Thejaka Perera
Vice President- Litigation, DFCC Bank PLC

David Bowie is a "Rock star". He is very recognizable from his flamboyant appearance. His music is very popular. However the lesser known fact is that, he is the originator of a pioneering financial transaction. He is responsible for the most famous Intellectual Property (IP) securitization, the Bowie Bond.

Based on part of David Bowie's back catalogue, the bond was launched in 1997and raised US$55 million. Moody's gave it an "AAA" rating. This was long before the financial crisis. The Bowie bond did not perform well, that is not due to any of the structural issues, but it fell victim to the music sharing provided by the internet and the resultant mass scale proliferation of copyright infringements that affected the music industry.

Since then a number of artists have released copycat bonds. The music industry not only discovered IP securitization but also is responsible for the greatest number of IP securitizations. Historically, the practice of obtaining financing secured by one form or another of IP, while relatively rare, was not unheard of. One well-known instance of using IP as collateral occurred when Thomas Edison used his patent on the incandescent electric light bulb as collateral to secure financing to start his company, the General Electric Company.

However, lending partly or wholly against IP assets is a recent phenomenon even in developed countries. Collateralizing commercial loans and bank financing by granting a security interest in IP is a growing practice, especially in the music business, Internet-based SMEs and in high technology sectors.[1]

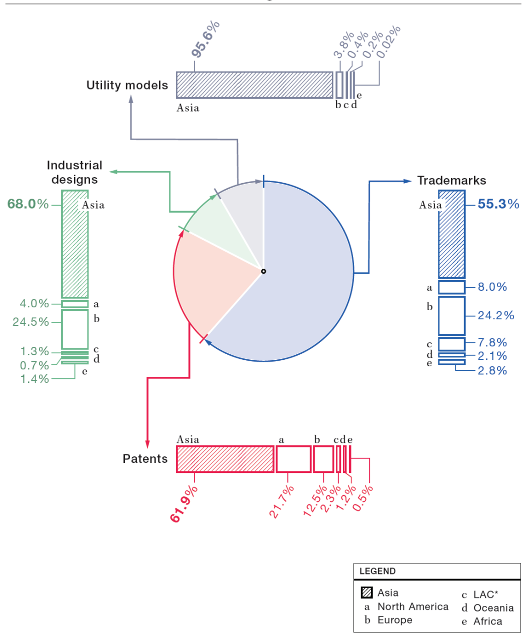
IP assets are increasingly being recognised as key business assets. Their management, including IP to fund business activities, is now said to be "a part of corporate strategy". In addition, there is an increasing desire on the part of most IP owners to turn them from being a cost to a profit centre. Figures quoted to support this thesis are impressive. Ninety per cent of worldwide corporate net worth can be attributed to intangibles and IP.

Taking data form USA alone:

- America's IP is worth $6.6 trillion, more than the nominal GDP of any other country in the world.
- IP-intensive industries account for over 1/3– or 38.2%– of total U.S. GDP.
- IP accounts for 52% of all U.S. merchandise exports- which amounts to nearly $842 billion.The direct and indirect economic impacts of innovation are overwhelming, accounting for more than 40% of U.S. economic growth and employment.[2]

This trend is not limited to USA alone. The changing global economics are reflected in the recently published data by the World Intellectual Property Organisation (WIPO).

Asia received the bulk of world IP filings



2. Shares of IP filing activity by region

* Latin America & Caribbean (LAC)

Source: WIPO Statistics Database, October 2016

Therefore, there is clearly no lack of encouragement for companies and their financial advisers to use these key assets in their financing. Also it is enticing to the financiers; inter alia Banks to offer funding on the strength of the IP rights owned by the borrowers. In addition, recent changes in accounting standards mean that increasingly companies have to carry out regular valuations of their IP assets, which obviously increases their visibility and transparency.

[1] World Intellectual Property Organisation http://www.wipo.int/sme/en/ip_business/finance/securitization.htm

[2] Global Intellectual Property Centre U.S. Chamber of Commerce http://www.theglobalipcenter.com/resources/why-is-ip-important/

So why haven't the banks tapped this gold mine yet? Is it the ignorance or risk averseness or the lack of infrastructure in terms of legal and regulatory spheres that keep the banks away?

Most bankers would understand the concept of mortgage agreement, and will understand at least the basic features of the assets that have historically been used for financing structures. In contrast, very few bankers have ever seen an owner of an IP right. (Interestingly the writer, during his branch banking days, met a script writer who wanted to borrow against a manuscript of a tele film, the request was prudently declined.) Therefore, fear of the unknown is clearly a factor. This article aims to study these aspects further.

What is intellectual property?

Intellectual Property Act, No. 36 of 2003 of Sri Lanka recognises various classes of IP. Copyrights, Industrial Designs, Patents, Trade Names and Marks and Layout designs of Integrated Circuits are some of them. In addition WIPO recognises plant varieties and utility models etc. However in order to understand the concept of IP for the purpose of collateralization let us understand the following three main categories.

- **Patents**

A patent is a monopoly right that enables the proprietor to prevent others from using the technology developed by it without its licence. A patent lasts for a fixed period (20 years). Therefore, by licensing third parties to use the underlying technology of the patent, the proprietor can generate regular cash flows in the form of royalty payments. Patents with several years of proven licensing revenues or patents relating to technologies that form part of industry standards will provide good opportunities for investors.

- **Copyright**

Copyright arises automatically in original literary, musical and artistic works that are recorded. Such works include computer software, music, books and films. The copyright enables the proprietor to prevent third parties from copying the copyright works for a period of 50 or 70 years after the death of the author. Those which show stable cash flow generation will be particularly attractive to investors.

- **Trademarks**

Trademark protection can be granted in respect of anything that can be represented graphically (e.g., brands, colours, shapes). A trademark owner has the exclusive right to use its trademark in relation to the products and services for which the trademark is registered and it can prevent others from using it. Trademarks last indefinitely (subject to the payment of renewal fees and continued use). Brands that prove their popularity over extended periods of time will be particularly attractive to investors.

Factors to be considered in IP financing

Although IP assets are capable of generating large cash flows, using them as the basis for collateral is not straight forward. The difficulties have sometimes been exaggerated and the fact that many bankers are relatively unfamiliar with IP rights has not helped. However, there are a number of issues which are peculiar to IP assets that need to be understood and addressed before embarking on this type of deal, including the following:

• Valuation – the intangible nature of IP assets makes accurate and reliable valuation difficult. In particular, valuation linked to the cash flow generation potential of the asset is extremely difficult; especially as events beyond the control of the IP pledger/borrower may affect the level of cash flow. However, methods of modelling predicted cash flows are becoming more sophisticated and reliable. The concept of valuation is being studied in detail later in this article.

• Jurisdictional differences – IP assets are predominantly national rights, subject to the Jurisdiction of the territory. There is no uniform worldwide patent, copyright or trademark law. If the IP assets to be pledged are from a number of jurisdictions, the due diligence process will require legal expertise in all the jurisdictions concerned, which can significantly increase the overall cost of the transaction.

• Extensive due diligence and credit appraisal – due diligence costs associated with IP rights can be high. Assessing the validity of patents and proving title to copyright, for example, can require costly expert legal evaluation.

• High administration costs – in order to maintain the value of IP assets it may be necessary to pay: legal fees to enforce the lender's right to prevent unlicensed use of the IP assets by third parties; legal fees to defend validity/ownership challenges in respect of the IP assets; administrators to ensure that renewal fees in respect of patents and trademarks are paid prior to registry deadlines to avoid inadvertent lapse; and renewal fees themselves.

• Unpredictable cash flow – the IP pledger may be due to pay back a debt instalment at a time when the cash flows generated by the IP assets are insufficient or, worse, when the IP assets actually produce a loss. However, default on the loan in these circumstances can be avoided by using credit enhancement techniques such as over-collateralisation, third-party guarantees and insurance policies.

• Obsolescence – with regard to patents, a previously successful patent may be superseded by a subsequent technology, thereby dramatically reducing its cash generating capacity.

Valuation of IP

Valuation is a key tool in the process of financing based on IP assets. Technical valuations are required of intangible assets to give a point in time value of the IP for the purpose of collateralisation. The available methodologies for IP valuation work best with patents and Trade Names and Marks. So far, no standard methodologies have been developed that are generally applicable to all IP.[3]

Rank	Brand	Brand Value	1-Yr Value Change	Industry
#1	Apple	$170 B	10%	Technology
#2	Google	$101.8 B	23%	Technology
#3	Microsoft	$87 B	16%	Technology
#4	Facebook	$73.5 B	40%	Technology
#5	Coca-Cola	$56.4 B	-4%	Beverages
#6	Amazon	$54.1 B	54%	Technology
#7	Disney	$43.9 B	11%	Leisure
#8	Toyota	$41.1 B	-2%	Automotive
#9	McDonald's	$40.3 B	3%	Restaurants
#10	Samsung	$38.2 B	6%	Technology

The top ten brand values[4]

The value of an IP is a monetary compensation that is expected to be received from licensing of an IP or from sale or exchange of other intangible assets. The intangible assets of a company include goodwill, trademark, technology, know-how, trade secrets, etc. During a merger or an acquisition the asset acquisition are accounted for based on the value of the assets exchanged. The assets and liabilities of the subject company are restated from their historical basis to their fair market value.

The most common hurdles with IP valuation usually fall into three categories; first, lack of active markets and a good set of comparables, second, lack of transparency in valuation methods and third the nature of intangible assets makes their value “contextual”. In general accounting standards are generally not helpful in representing the worth of IPRs in company accounts and IPRs are often under-valued, under-managed or under-exploited.

There are four main value concepts, for IPR:

• Owner value. It often determines the price in negotiated deals and is often led by a proprietor’s view of value if he were deprived of the property.

[3] http://www.wipo.int/wipo_magazine/en/2008/05/article_0001.html
[4] https://www.forbes.com/powerful-brands/list/

• Market value. It is the assumption that if comparable property has fetched a certain price, then the subject property will realize a price something near to it.

• Fair value. It is based on equitability to both buyer and seller. It recognizes that the transaction is not in the open market and that vendor and purchaser have been brought together in a legally binding manner.

• Tax value. It has been the subject of case law worldwide since the turn of the century and is an esoteric practice.

The above concepts of value impose upon investment value, liquidation value, and going concern value. Acceptable methods for the valuation of identifiable intangible assets and IP fall into three broad categories. They are market based, income-based and cost-based.[5]

- Market-based approach

The market-based approach is a valuation method that estimates the value based on actual market transactions. It requires the collection of market data from comparable transactions and analysis of the data to estimate the value of the brand or intangible through comparison and correlation.

- Income-based approach

This approach considers income and expense data relating to the intangible and estimates the value through a capitalization process. Capitalization relates to income (usually a net income figure) and value by converting an income amount into a value estimate. This process may consider direct relationships (capitalization rates or multiples), yield or discount rates (reflecting measures of return on investment), or a combination of these. The methods of valuation flowing from an estimate of past and future economic benefits can be further broken down into four as follows:

1. Capitalization of historic profits,

Capitalization of historic profits is arrived at the value of IPR's by multiplying the maintainable historic profitability of the asset by a multiple that has been assessed after scoring the relative strength of the IPR.

2. Gross profit differential methods,

Gross profit differential methods are often associated with trade-mark and brand valuation. These methods look at the differences in sale prices, adjusted for differences in marketing costs.

3. Excess profits methods,

Excess profits method looks at the current value of the net tangible assets employed as the benchmark for an estimated rate of return. This is used to calculate the profits that are required in order to induce investors to invest into those net tangible assets.

[5] Managing Intellectual Property: The Strategic Imperative Vinod V. Sople 3rd Edition

4. Relief from royalty method

Relief from royalty considers what the purchaser could afford, or would be willing to pay, for a licence of similar IPR. The royalty stream is then capitalized reflecting the risk and return relationship of investing in the asset.

Discounted cash flow (DCF) analysis falls into the last three methodologies and is probably the most comprehensive methodology to calculate the value of an asset. IPRs have a varying ability to generate economic returns dependent upon their total utility lives. For example, in the discounted cash flow model, it would not be correct to drive out cash flows for the entire legal length of copyright protection, which may be 60-plus years, when a valuation concerns computer software with only a short economic life span of 1 to 2 years.

- Cost-based approach

This approach takes into consideration the value of intangible assets on the basis of their 'cost to create' approach. For brands, such costs typically include naming, research and product design, packaging, design, advertising and promotional cost. A portion of promotional payout, and short-term maintenance cost is only part of it creates long-term brand value. Consideration is given to all costs associated with replacing or replicating the asset. The depreciation is deducted from that. Here, it may be little or no correlation between the development costs and the impact on financial performance (revenues and profits). The 'cost to create' approach may, therefore, understate the price at which the asset would change hands between willing parties in an arm's length transaction. The method ignores changes in the time value of money and ignores maintenance.

- Challenges in IP valuation

Valuation of royalty income in patents and technology can present many unique challenges. Indeed, when dealing with technology, the question of obsolescence also comes into play. For patents and trade secrets, the valuation of these assets requires a deep understanding of the legal, technical, and economic issues surrounding the inventions. Similarly, a substantial amount of expertise is required to value marketing assets such as trademarks and trade names.

IP valuation is a complicated process because of the large number of impacting factors. These include accessing market comparables, determining IP risk, handicapping potential licensees, and calculating the uncertain economic benefits to be generated by IP assets. There are many sources which enumerate methods of IP valuation for licensing, but a few provide real-life applications or guidelines. The valuation of IP presents different challenges to valuing businesses and shares. It requires careful consideration, the application of complex methodologies and commercial judgment.[6]

[6] Managing Intellectual Property: The Strategic Imperative Vinod V. Sople 3rd Edition

Modalities of using IP as collateral

For many IP centric companies suffering from cash flow constraints, traditional financing options may be unavailable or too expensive to pursue. Using IP as collateral is an emerging business option that may offer a financing opportunity for companies with valuable IP assets seeking alternative sources of capital, especially for start-ups.[7]

Even for established companies, financing requirements may arise from marketplace challenges, the need to expand, or a countless other reasons. For instance, following the 2009 recession, companies experienced difficulty in securing capital as banks restricted the number and amount of loans to businesses. Fortunately, for some businesses, a realistic alternative to traditional financing is collateralization of their IP assets.

In the context of IP, collateral can be defined as a borrower's pledge of specific property, such as future cash flows from existing IP assets, or rights to the underlying IP itself, in order to provide recourse for the lender in the event of loan default. In recent years, however, it has become increasingly common for lenders to file liens against IP assets.

Specialty lenders offer a wide range of financing vehicles for borrowers who wish to use their IP to secure funding. Ranging from traditional loans to mezzanine debt with equity conversion clauses, lenders and investors can now structure many creative forms of financing based on a borrower's specific capital needs. Some of the more common uses of IP as collateral: IP-backed loans, IP collateral enhancement, IP royalty securitization, and IP sale and license-back transactions.

- IP-backed loans

For conventional asset-backed loans, lenders typically turn to physical assets, such as inventory, machinery, or real estate, in determining loan size and terms. The borrower grants a security interest in these assets to the lender as collateral against the loan. IP-backed loans are similar to their tangible asset-backed counterparts. Under these arrangements, a company can borrow a percentage of the value of certain of their IP assets using these intangible assets as collateral. For both tangible and intangible assets, asset-based lenders assess credit risk, at least partially, on the basis of the value and liquidity of the underlying collateral.

This type of secured lending is often a desirable form of borrowing for companies that have valuable IP, but a lack of unencumbered tangible assets, a sufficient credit rating, or an adequate track record of generating excess cash flows to qualify for more traditional types of financing, debt capital markets, or unsecured bank borrowing.

[7] https://www.stoutadvisory.com/insights/article/financing-alternatives-companies-using-intellectual-property-collateral

IP Collateral Enhancement

IP collateral enhancements (e.g., insurance or guarantees on the value of the IP for a defined duration) reduce credit and foreclosure risk, thereby improving the overall credit profile, increasing leverage available to the borrower, and possibly lowering interest rates demanded by the lender. By guaranteeing the value of IP, firms offering IP collateral enhancements make it easier for companies to use IP as collateral for loans.

- IP royalty securitization

There are many forms and legal structures used to facilitate IP royalty securitization. However, IP royalty securitization itself is a relatively straightforward process that involves the IP owner pooling and selling future IP-related income streams in exchange for a current lump-sum payment. In a typical securitization, in exchange for a lump-sum payment and a royalty-free license, the IP holder would transfer the IP assets to a special purpose vehicle ("SPV"). All future earnings generated by the IP assets flow to the SPV, which are then distributed to investors. Under this deal structure, the original IP asset holder no longer is the legal owner of the IP assets; hence, the assets are shielded from creditors in the case of the original IP owner's bankruptcy.

The difference between this financing method compared to an IP-backed loan described previously is that the IP owner securitizing its assets is not borrowing money, but rather is selling a stream of anticipated future cash flows that would otherwise accrue to the owner of the IP assets. Furthermore, unlike IP-backed loans or traditional bonds, with securitization, the burden of repayment is shifted away from the originator to the designated pool of assets. The originator is therefore protected from the operating performance of the securitized assets.

Securitization normally refers to the pooling of different financial assets and the issuance of new securities backed by those assets. In principle, these assets can be any claims that have reasonably predictable cash flows, or even future receivables that are exclusive. Thus securitization is possible for future royalty payments from licensing a patent, trademark or trade secret, or from musical compositions or recording rights of a musician.

At present, the markets for IP asset-based securities are small, as the universe of buyers and sellers is limited. But if the recent proliferation of IP Exchanges on the Internet is an indication, then it is only a matter of time before all concerned will develop greater interest and capacity to use IP assets for financing business start-ups and expansions. As more cash flows are generated by IP, more opportunities will be created for securitization.

- IP Sale and License-Back arrangements

IP sale and license-back financing is worth considering for companies looking to raise capital. Sale license-back financing is similar to the sale lease-back model of real estate and occurs when the IP assets are purchased and assigned to a licensing company (the back-licensor).

Concurrently, the back-licensor contracts a license to the same asset to its former owner (now the back-licensee) for stipulated royalty payments during a specified period of time. The arrangement can have a purchase option whereby the back-licensee can exercise the option to buy back the ownership of the asset at a fixed price at the end or during the back-license contract period. The company receives immediate funding to reinvest in the business, and the back-licensor company can structure the contract to pursue additional monetization of the asset. This financing mechanism allows the IP asset owner to secure funding through the sale of its IP portfolio, without inhibiting the utilization of the asset in its business operations.

Integrated risk analysis of IP collateralisation

1. Underlying asset risk

This is the type of risk that depend on the particular financial, credit and other characteristics of the assets that are used as collateral for the securities issued in the course of collateralisation. The underlying asset risk can be addressed by picking the assets for collateralisation that have understandable credit characteristics and that are homogeneous with predictable cash flows, low historical delinquency and high liquidation value.

For example, credit card loans have historically predictable and understandable credit terms with low level of defaults which makes them more attractive for Collateralisation than patents or copyrights.

2. Legal risks

a. Bankruptcy risk

In the case of a direct borrower the proper charge on the IP needs to be created and in the case of a securitization the bankruptcy remoteness of the SPV needs to be ensured

b. Property title and transfer risk

For all structured finance deals the title of ownership that is transferred from the borrower is one of the key issues. If it turns out that the original borrower did not have the right of ownership for the copyright or patent or if this right is not perfected so that there is a chance that it can be challenged by another having a legitimate claim against the owner of the copyright, the whole financing is under risk.

c. Free-rider (Fair use) risk

Another important risk that may affect the outcome of an IP asset securitization is the “fair use” risk. This risk exists for most IP assets. But it is especially important for copyrights.

Unlike most other assets included into structured financings, copyrighted works can sometimes be used without consent of the copyright owner. This right is known as the “right of fair use.” This is another caveat that should be considered when planning for collateralisation of copyrights.

d. Regulatory uncertainty risk
This is the risk of new regulations being issued affecting the transaction.

3. Commercial risk

This risk is present when a bank invests in Research and Development stage of a patent that is yet to prove the ability to be exploited commercially.

4. Credit risk

This is an obvious risk that needs to be taken to account when appraising (and will not be discussed in this article).

Advantages and disadvantages of IP as collateral

Given the growing recognition of IP as an asset to be collateralized, there are a number of advantages and disadvantages to consider when looking into the financing options mentioned earlier, including:

Advantages of using IP as collateral

- IP offers different avenues for monetization to the asset owner by increasing the pool of available credit to a borrower. Corporations are able to receive additional leverage and/or a lower cost of funding if a company is able to secure credit from lenders for its intangible assets as compared to relying solely on tangible assets for financing.
- IP can increase the owner's return through leveraging. Monies secured through financing are collected in one lump sum rather than over time and the lump sum can then be invested in projects that are expected to have a higher return than the cost of financing.
- IP provides a conduit to financing that doesn't cause the dilution of the existing equity positions and may be less expensive than certain other alternative financing options.
- It may be more attractive to finance the IP assets on a basis that is predicated on the strength and performance of the IP assets rather than the creditworthiness of the borrower. If the IP assets are a consistently revenue-generating part of the company, they may have a more attractive cash flows stream for lending than the company as a whole, which may lead to lower execution costs.
- IP-based financing may offer some options for businesses to hedge themselves from risks. With securitization, for instance, the obligation of the IP's performance is shifted away from the originator and the assets are safeguarded from bankruptcy proceedings.

Disadvantages of using IP as collateral

- If the IP is the company's primary asset and pledged as collateral, a default on the loan could result in the loss of the IP and a termination of the company.
- More established forms of collateral, such as tangible property, are generally more stable and often provide lenders with readily-available market information when assessing the value of the property. Because the valuation of IP is generally more difficult than for tangible assets, potential creditors are less willing to invest because they know less of how the market will react to the property in the future.
- Tangible assets are often easier to liquidate than IP. Due to the unique nature of IP, the pool of potential buyers may be more restricted compared to the group of willing buyers for tangible assets.
- IP-based collateralized financing is still considered a somewhat emerging market, and with a limited number of lenders who are comfortable extending loans against IP assets, it can be a more expensive alternative than traditional financing options.
- For an asset to have value, it must be able to be discretely identified. For certain IP assets, there may be difficulty in meeting this requirement. For instance, the success of a product may reflect its use of patents, trade secrets, copyrighted materials, and marketing assets such as trade names or trademarks.

Benefits of IP collateralisation to the Banks in view of capital restrictions under Basle III

Several US banks want to tap the value of the IP holdings of their borrowers as a way of trimming their capital requirements, which are to be made tougher under Basel III rules. Under the terms of many loans, banks have the right to seize a borrower's patents and trademarks as part of a foreclosure proceeding. But these intangible assets cannot generally be counted towards the loan's security for regulatory capital assets because they are considered too difficult to value. Now some banks – faced with tougher safety rules that begin to take effect, are exploring whether they can use the assets to reduce their estimates of expected losses in case of a default, and in turn reducing the risk weight of the loan and overall capital requirements.[8]

Conclusion

IP securitisation remains a valid financing technique which allows rights holders to obtain the financial benefits of present lump sum cash in exchange for the right to receive royalties from their works over the long term. For a collateralisation of IP to be successful the value of the royalty stream in question must be predictable and the risks that may undermine the demand for the goods protected by the IP must be understood.

---

[8] FT June 12, 2012 by Brooke Masters, Chief Regulation Correspondent https://www.ft.com/content/80c23e56-b08f-11e1-8b36-00144feabdc0

As technology evolves it may be difficult to predict how market forces (e.g., peer-to-peer file sharing) may impact IP valuation and such uncertainty may temper enthusiasm for this financing technique. However, with appropriate due diligence precautions, cautious asset identifications and careful valuations collateralisation of IP is viable and should be considered as a way to monetise IP.[9]

IP financing, or the use of IP assets (trademarks, design rights, patents and copyright) to gain access to credit, is gaining increasing attention in IP circles. Multinational corporations as well as small and medium sized enterprises, are leveraging their IP assets in exchange for finance, and lending institutions around the world are increasingly extending their business to provide loans on the basis of IP.[10]

From a legal perspective, it is interesting to note that most jurisdictions still do not offer adequate legal means for financing intangible assets, including IP. While some sectors of academia are aware of these shortcomings, it appears that there is not yet sufficient political motivation to modernize these legal systems. As such, the issue of IP financing is currently the subject of policy development at the international level.

Yet an enforceable legal protection for IP collateral can be obtained by the creative use of existing licensing and assignment provisions. However the political proponents that propose knowledge based economy for Sri Lanka should seriously consider implementing a more conducive legal and regulatory framework enabling the financial utilization of IP rights in Sri Lanka.

---

[9] http://www.buildingipvalue.com/05_NA/143_146.htm (Keith W Medansky and Alan S Dalinka Piper Rudnick LLP, Chicago, IL)

[10] http://www.wipo.int/wipo_magazine/en/2008/05/article_0001.html