Intellectual Property Securitization: How Far Possible and Effective

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Over the past decade and a half, there has been a steadily increasing focus on intellectual property (IP) and its proceeds as sources of funding and collateral security. More than ever, IP is being recognized as a valuable component of a company’s asset portfolio due in large measure to the growth in IP as a strategic investment. The use of IP collateral is often more attractive than other types of collateral because there is generally a lower credit risk, which results in a lower cost of financing, and pledging IP collateral will often allow a borrower to secure financing without the need to alter its capital structure. The present paper discusses the issues related to patent securitization and concludes with a statement of how far patent securitization is possible and effective.

Keywords: Financial asset, perfection, IP securitization, security interest

Intellectual property securitization has taken a variety of forms since its creation in the mid-1990s. These have included music royalty, future film and trademark licensing receivable transactions. IP-backed securitization consists of the transfer of IP by an owner for securitization and the receipt of capital from investors in the form of lump sum payments. Typically royalty streams from IP serve as capital for investors. IP-backed securitization remains a small portion of total asset-backed securitization in terms of total investment and number of deals completed. Several factors account for its limited use, including piracy risks, concerns over litigation, potential changes in legislation and technological obsolescence. With drug patents, additional concerns relate to possible withdrawals of patented drugs from the market.¹

Keeping these in mind, one can understand that IP-backed securitization involves more technical expertise than traditional asset-backed securitization and consequently requires more substantial due diligence than conventional asset-backed securitization. Thus, IP-backed securitization may require larger transaction scales to be successfully accomplished. Securitization of IP differs from securitization of other kinds of assets like mortgages or credit cards. Most asset-backed securitizations are based on loans, which pay a fixed amount (excepting for a predictable number of defaults). IP-backed securitization, however, is likely to pay out variable royalties due to fluctuation in sales. Although some enthusiasts of IP securitization emphasize the similarities between the securitization of mortgages and IP assets, in fact, IP-backed securitization comes with a unique set of wrinkles:

(i) Increased difficulty in predicting future cash flows due to a variety of specific risk factors unique to the IP.
(ii) IP valuation, while growing in acceptance, remains a developing area and disputes over methodology can decrease confidence in the soundness of potential IP securitization deals.
(iii) IP value can be affected by non-registered factors, such as know-how or confidential information.
(iv) Infringement action (most obviously music piracy) can seriously erode revenue streams and plans for combating infringement through litigation must be in place in order to protect the value of the IP.

Given the above risks and complexities, due diligence on IP before securitization is more expensive than with traditionally securitized assets.²

In spite of the manifold complexities, IP-backed securitization is making some headway in the music (based on copyrighted music) and pharmaceutical industries. In 1997, musician David Bowie financed USD 55 million by securitization of future royalty streams resulting from his 25 albums.³ In 2000, Royalty Pharma arranged the securitization of the patent for the HIV-drug Zerit, property of Yale University, but the deal defaulted due to low sales.⁴
Process of Patent Securitization

In a typical IP securitization, the royalty stream is transferred to a special-purpose, bankruptcy-remote vehicle (SPV). The transaction is tailored to be a ‘true sale’ rather than a form of lending secured by the transferred assets. This step is taken to ensure that the issuer, the SPV, and the assets will not be affected by the originator’s bankruptcy. If the transfer is considered a loan, then a court may deem the assets to be owned by the transferor, leaving the issuer with only a security interest in the assets. Such a result in bankruptcy would affect investors’ ability to receive payments on time.

The SPV then issues securities to capital market investors. Usually the bonds are privately placed to institutional investors, such as pension funds or insurance companies, not to the general public. The transfer to the SPV places the IP assets out of reach of the originator’s unsecured creditors.

A portion of the capital obtained from the issuance of the bonds may need to be placed in a debt service reserve fund.

Ratings are assigned to the securities by a rating agency or agencies. Typically, rating agencies accept 3-5 years of history with a particular company’s portfolio as being sufficiently reliable data to project future performance.

Before the IP is securitized, it may be necessary to acquire additional IP which could be ‘choke points’ if left outside the vehicle. It may also be necessary to obtain residual value protection, such as, insurance, for deals in the case of underperformance of the royalties. The process of securitization, in general, is not much different from mortgage in terms of the regular cash flow.

Cost and Benefits of Patent Securitization

The fact that a certain IP or IPR is securitizable does not always mean that the securitization scheme for these, functions well. Consideration should be given from the perspective of ‘cost benefits of securitization’.

The asset to be securitized must have a reasonable size. As a considerable amount of costs are usually needed to build a securitization scheme, the amount of fees to be paid to a law firm or accountant’s firm is expected to be accordingly large. For this reason, in Japan, the standard amount of asset to be securitized, which may indicate the break-even point, has been recognized as ranging from 2 to 10 billion yen. This amount also seems to be set based on the scheme in which credit enhancement is adopted for the purpose of protecting investors against loss or obtaining a high rating for securities issued. In any case, it is unquestionable that the IP to be securitized is required to have reached a reasonable size.

The Scalar case, the first case of securitization of patent rights in Japan, was a securitization scheme that was successfully composed, but this was an ‘experimental’ case of securitization carried out by members of the ministerial workshop. The amount of funds actually raised through securitization was only about 200 million yen, and for such an amount, it would normally be difficult to acquire benefits that are sufficient to cover the costs to be paid to professionals in law, accounting, tax, and financial affairs, which are considered necessary for setting up such complicated schemes. Though adopting a form of securitization by transferring the patent rights to the SPV, the scheme, when viewed as a whole, seemed to have raised funds by offering royalties to be paid by pin change as substantive reserves.

In the Shochiku case, securitization of royalties was initially considered, but out of concern for legal instability as to how the license contract would be handled in the event of the originator’s bankruptcy, the scheme of transferring the ground-based broadcasting rights per se was finally chosen.

Problems in Patent Securitization

Problems concerning patent securitization may be roughly divided into those relating to: (1) characteristics of the assets to be securitized, (2) transfer of assets to be securitized, (3) credit enhancement, (4) issue of securities, and (5) handling after the implementation of the securitization.

The first point is related to the characteristics of the target of IP securitization. In almost all cases where securitization seems to be implemented for intellectual property rights (IPRs), the assets that are actually targeted are royalties for the IPRs. To specify the assets to be securitized, it is necessary to correctly identify the relationship between the IPRs concerned and third parties’ rights.

Secondly, there are many problems concerning the transfer of assets to be securitized, including (i) transferability, (ii) true sales, (iii) effectiveness against third parties, (iv) risk of cancellation of a license contract, and (v) evaluation of the IP concerned. In relation to the issue of transferability, consent should be obtained from the parties concerned when securitizing exclusively personal rights (e.g. the
moral right of an author) or jointly owned rights. The issue in true sales is the extent to which the originator is allowed to continue to have involvement in the securitized assets.

As far as effectiveness against third parties, registration is required for a patent right, utility model right, design right, and trademark right to take effect. Registration is required for a copyright and right of layout-designs of integrated circuits to become effective against third parties. Risk of cancellation of a license contract means that, in the event of the bankruptcy of the licensor, the administrator might cancel the license contract. The issue of evaluation also arises when there is no market for the IPR concerned and therefore it is difficult to assess the correct amount of cash flow that will be generated from the IPR. There is also a risk that a patent right might become invalid and lose its effect.

The third point relates to credit enhancement. In case of an IPR to be generated in the future, it is so difficult to evaluate the risk of failure to completely establish the IPR that even a credit enhancement such as insurance would not pay due to the high insurance premium rate.

The fourth point is concerned with how to balance disclosure to investors with confidentiality of technical information when issuing securities.

Finally, there are points to be noted after the implementation of the securitization, such as how to treat patents of improvements and include them in the scope of assets to be securitized, and how to handle the payment of annual fees for patents. Consideration is also required regarding the involvement of the originator in the event of an infringement of the IPR, and how to cope with the issue of true sales where the originator is actually involved.

**Patent Securitization in USA**

In USA, the important and ongoing issue is the perfection of security interest. US Patent law is governed by Title 35 of the US Code. A patent is commonly treated as a ‘general intangible’ for purposes of Article 9 of the Uniform Commercial Code (UCC) which governs secured transactions—consensual transactions involving the granting of credit secured by personal property. The UCC does not apply to all secured transactions like security interests subject to a Federal statute to the extent that such statute governs the rights of parties to and third parties affected by transactions in particular types of property. On the other hand, Federal law contains recordation and priority rules governing the issuance or registration of patents, trademarks and copyrights. Federal law is not exhaustive in nature and merely gives a broad outline about perfection and priority of security interest. As the operational area of UCC and Federal law is not clearly distinguished, it gives rise to procedural problems as to perfection of a security interest. Thus the issue is the requirement of filing under Article 9 UCC and 35 U S C §261.

The controversial *Peregrine* decision, mentioned below in connection with copyright, held by way of *obiter dicta* that security interests in patents and patent applications are perfected by filing in the USPTO. However, an earlier decision had held that a security interest in a patent could be perfected under the UCC. Subsequent to *Peregrine*, a 9th Circuit appellate decision held that because the Patent Act is not sufficiently comprehensive to exclude state methods of perfecting security interests, and registration of security interests under the Patent Act is discretionary, the state UCC laws are sufficient to provide the sole method of perfection. Thus, a UCC filing of a security agreement may be sufficient to protect a secured lender against another lien holder or a bankruptcy trustee, at least in the 9th Circuit but a USPTO (US Patent and Trademark Office) filing may still be necessary to perfect a security interest in a patent against a subsequent purchaser for value. Some experts believe that the safe course of action, once again, is a ‘belt and suspenders’ approach. These experts recommend dual filings at the USPTO and under the UCC. In the view of Susan Barbieri Montgomery, who was chairperson of the American Bar Association (ABA) Intellectual Property Committee that introduced the Federal Intellectual Property Security Act (FIPSA) proposal in 1999, the preferred result would be that perfection of a security interest in a patent ought to be achieved by the filing of financing statements under the UCC. She recommends that dual filing might be necessary to perfect a security interest involving a patent against certain parties. In an important recent ruling, the United States Court of Appeals, the 9th Circuit Court of Appeals has ruled that the Federal Patent Act does not preempt state UCC legislation and that filing with the USPTO is not necessary to perfect a security interest in a patent under US law. The Court distinguished the finding in *Peregrine* and the situation with respect to copyrights by stating that the court in *Peregrine* observed that Federal copyright laws ensure predictability and certainty of copyright
ownership, promote national uniformity and avoid the practical difficulties of determining and enforcing an author’s rights under the differing laws and in the separate courts of the various States.

**Patent Securitization in India**

Neither Securitization, Asset Reconstruction and Enforcement of Security Interest Act, 2002 nor Patent Act, 1970, have contemplated patent securitization in India, and this may be one of the major reasons why patent securitization in India is yet to develop. This part of the paper aims at analysing patent securitization with respect to these Acts and to understand whether patent securitization in India is possible under these Acts or not. A typical securitization transaction as per the Indian Act consists of the following steps:

1. Creation of a special purpose vehicle to hold the financial assets underlying the securities.
2. Sale of the financial assets by the originator or holder of the assets to the special purpose vehicle, which will hold the assets and realize the assets.
3. Issuance of securities by the SPV, to investors, against the financial assets held by it.

This process leads to the financial asset being taken off the balance sheet of the originator, thereby relieving pressures of capital adequacy, and provides immediate liquidity to the originator. Its purpose is to promote the setting up of asset reconstruction/securitization companies to take over the non performing assets (NPA) accumulated with the banks and public financial institutions. The Act provides special powers to lenders and securitization/asset reconstruction companies, to enable them to take over of assets of borrowers without first resorting to courts. An overview of the process reveals that a number of parties are involved in the securitization process which may be responsible for slow evolution of this process. Another problem in India is the lack of powerful players in the Indian market economy and a small company or bank would not like to take up that much of risk.

Perhaps traces of security interest creation over patents may be collected from Indian Patent Act. In India, a patent can be assigned, sold, licensed or any interest can be created over it under Section 68 of the Patents Act, 1970 (ref. 18). Though the purpose of the Section is to give procedural guidelines, it gives an impression that creation of security interest on patents is possible in India.

Possibility of patent securitization is not important; rather how far and how effectively it can be done needs scrutiny. Indian Securitization Act is primarily for banking purposes whereby there is an alternative method of generating revenue of NPA. It is however, doubtful that the same method can be applied for complex securitization processes like patent or say trademark securitization. The pros and cons of existing legislations which can assist in securitization is analysed:

(1) Section 2(1) of Securitization, Asset Reconstruction and Enforcement of Security Interest Act, 2002 (ref. 19) defines ‘financial asset’ and has used the term property. It is not clear however, whether IPR fall within the ambit of property as defined.

(2) In Indian Securitization Act, two structures of securitization are possible, ‘pay through’ and ‘pass through’. In ‘pass through’, the investor possesses a charge over the property which means in normal assets like mortgage, loan is certain and definite. It is a not certain that this would apply in case of patents since value may fluctuate and is not definite.

(3) ‘Bond investors’ has not been discussed in Indian Securitization Act, in absence of which, securitization of normal assets may work but patent securitization cannot, since, without issuance of bond neither debt service reserve fund will be effective nor can bonds be issued in the capital market.

(4) A healthy patent securitization is possible only after patent valuation, which should be done by either professionals or certain specified agencies/companies; which are also absent in Indian Securitization Act. In such a case there is always a chance that patent securitization may fail.

(5) It would also be difficult to adopt the same method of securitization as one does for mortgage or loan because in that case, though the risk is uncertain, the fate is certain. Available data may give predictions. For IP, particularly patents, there is not as much raw data and comparative tables would not be helpful because, while two auto loans are virtually the same with respect to risk profile, two prescription drugs are very different.

(6) Securitization of IP differs from securitization of other kinds of assets like mortgages or credit cards. Most asset-backed securitizations are based on loans, which pay a fixed amount (excepting for
a predictable number of defaults). IP-backed securitization, however, is likely to pay out variable royalties due to fluctuation in sales.

Though knowingly or unknowingly, by use of certain terms patent securitization has been made possible according to the Patents Act but the above mentioned issues remain unresolved by other existing Acts like Securitization, Asset Reconstruction and Enforcement of Security Interest Act, 2002. The question therefore, always remains whether patent securitization will be successful and that adds one more risk factor to the process.

Conclusion

It is apparent that securitization of IPRs involve various difficulties. Even in developed countries like US and Canada neither the market nor policy framers are fully prepared for IP securitization.

Of course, it may be possible to make IPR securitization successful by resolving these problems, but the applicable scope would be extremely limited, only including those cases in which the right itself can be easily divided or in which a small number of IPRs are directly linked to commercialization of the product. Furthermore, enormous costs are usually required to build a securitization scheme, so the volume of the securitized assets needs to be extremely large.

References

2 Nesbitt Harris, Asset-Backed Update, (Asset Securitization, USA), 2004.
4 The patent was licensed to Bristol-Myers Squibb, the security was issued for USD 115 million, and Yale received a lump sum of USD 100 million.
5 Choke points are those points which can reduce the efficiency of the entire system. In the present context the choke points are any incidental or ancillary IP which are so attached to the securitized IP that they cannot be segregated and if segregated leads to non functioning of securitized IP or reduces the profit. Choke points are also referred as ‘complementary assets’.
6 The fact that IP rights are for a limited period of time will not change the basic nature of the whole process. One difference that might be observed is irregular cash flow due to fluctuation in sale of the subject matter.
7 1 billion Yen is approximately equal to 8525000 USD.
8 Unlike a home appliance product or similar that requires a large number of mutually related patents for a single product, the number of patents used in a single product was relatively small and that played a decisive role in commercialization of the product in the Scalar case of patent securitization. This is considered to be one of the important factors that enabled patent securitization in this case.
10 ‘Perfection’ refers to the concept of maximizing all that can be done to protect the secured interest, to obtain the “highest measure of protection available to a security interest against competing interests”. Perfection is clearly the basis for the establishment of priorities under the provincial systems.
11 The definition of ‘general intangibles’ in Article 9 was designed to include patents, trademarks and copyrights within its scope. It states as ‘general intangible’ means any personal property, including things in action, other than accounts, chattel paper, commercial tort claims, deposit accounts, documents, goods, instruments, investment property, letter-of-credit rights, letters of credit, money, and oil, gas, or other minerals before extraction. The term includes payment intangibles and software.
12 35 US C §261, ‘An assignment, grant or conveyance [of a patent] 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.’
13 Peregrine Entertainment Ltd, 116 Bankr 194, 16 U S P Q 2d 1017.
14 City Bank & Trust Co v Otto Fabric Inc, 83 Bankr 780, 7 U S P Q 2d 1719.
18 Section 68: An assignment of a patent or of a share in a patent, a mortgage, licence or the creation of any other interest in a patent shall not be valid unless the same were in writing and the agreement between the parties concerned is reduced to the form of a document embodying all the terms and conditions governing their rights and obligations and duly executed.
19 Section 2 (l): ‘financial asset’ means debt or receivables and includes-
   (i) a claim to any debt or receivables or part thereof, whether secured or unsecured; or
   (ii) any debt or receivables secured by, mortgage of, or charge on, immovable property; or
   (iii) a mortgage, charge, hypothecation or pledge of movable property; or
   (iv) any right or interest in the security, whether full or part underlying such debt or receivables; or
   (v) any beneficial interest in property, whether movable or immovable, or in such debt, receivables, whether such interest is existing, future, accruing, conditional or contingent; or (vi) any financial assistance.
20 In pass through structure, SPV may act as either a trustee or there may be a special trustee appointed for this very purpose. In pay through structure investors only have a charge against the securitized assets, while the assets themselves are owned by the SPV.