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Bowie Bonds Sold for Far More Than a Song: The Securitization of Intellectual Property as a Super-Charged Vehicle for High Technology Financing

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BOWIE BONDS SOLD FOR FAR MORE THAN A SONG: THE SECURITIZATION OF INTELLECTUAL PROPERTY AS A SUPER-CHARGED VEHICLE FOR HIGH TECHNOLOGY FINANCING*

Jennifer Burke Sylva†

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I. THE FIRST SECURITIZATION OF MUSIC COPYRIGHTS' FUTURE ROYALTIES

In 1997, David Bowie issued the first music royalties future receivables securitization¹ as bonds,² which were sold privately.³ The

1. Securities include "any note, stock certificate, bond debenture, check, draft, warrant, . . . certificate of interest in property, tangible or intangible; . . ." 18 U.S.C. § 2311 (1994). As instruments giving their legal holders rights to money or other property, securities are instruments "which have intrinsic value and are recognized and used as such in the regular channels of commerce." *United States v. Canton*, 470 F.2d 861, 864 (2d Cir. 1972). Although the term "securities" refers to the document, "securitization" refers to the process by which a property right is created in that document. See Stephen L. Schwarcz, *The Alchemy of Asset Securitization*, in *NEW DEVELOPMENTS IN SECURITIZATION* 515, 517 n.1 (PLI Commercial Practice Course Handbook Series No. 704, 1994). The author states that the term securitization refers to the issuance of securities that are backed by the cash flows of an entity's future receivables. However, not all practitioners believe that the term may be defined so easily, especially when stated in the context of asset-backed securities. See Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1320, 1374-1375 (1991). The authors explain that "the term [securitization] is used to describe a wide variety of financial transactions, from the most basic mortgage-backed security to a complex offering of multiple layers of debt and equity interests in a single asset or pool of assets." Hence, the authors define securitization as:

the sale of debt or equity instruments, representing ownership interests in, or secured by, a segregated, income-producing asset or pool of assets, in a transaction structured to reduce or reallocate certain risks inherent in owning or lending against the underlying assets and to ensure that such interests are more readily marketable and, thus, more liquid than ownership interests in and loans against the underlying assets.

deal involving the singer/songwriter/musician is historically significant because it is the first time music sound recording and publishing royalties have been securitized and the first time privately held intellectual property rights have been securitized.⁴ The assets that backed the bonds in the Bowie transaction were the future royalties to his existing catalog of music copyrights.⁵ As a result of the Bowie bonds deal, it appears that a copyright holder may be able to obtain future royalty payments in a lump sum and for less cost than incurred through a traditional bank loan or, in the case of music copyrights, a distribution agreement.

This comment will expose significant factors in the Bowie bonds deal, will reveal the steps used in other asset-backed securitization models, and will illustrate how this financing method might translate to the high technology industry. This comment highlights a few elements that are unique to the high technology industry and distinguishable from the Bowie bonds transaction. The analysis will indicate that asset-backed securitization is a feasible financing alternative for a high technology company with a consistent stream of income generated by its intellectual property.

II. FANCIFUL FICTIONS IN THE THEATER OF FINANCIERS

Creative and innovative financiers have dreamt, developed, and produced new financial structures such as step-down stock, synthetic put bonds, debt-equity hybrids, and asset-backed securities. Securitization, asset securitization, and structured finance are interchangeable terms.⁶ Each refers to an entity's use of its assets to raise financing.⁷ Asset-backed securities are bonds which are collateralized by a spe-

Id.

2. A bond is:

[A] certificate or evidence of a debt on which the issuing company . . . promises to pay the bondholders a specified amount of interest for a specified length of time, and to repay the loan on the expiration date. A long-term debt instrument that promises to pay the lender a series of periodic interest payments in addition to returning the principal at maturity. In every case the bond represents debt—its holder is a creditor of the corporation and not a part owner as is the shareholder.

BLACK'S LAW DICTIONARY 178 (6th ed. 1990).

3. See Sam Adler, *David Bowie's \$55 Million Haul: Using a Musician's Assets to Structure a Bond Offering*, ENT. L. & FIN., Aug. 1997, at 1.

4. See *Bowie Ch-Ch-Changes the Market*, CFO: THE MAGAZINE FOR SENIOR FINANCIAL EXECUTIVES, Apr. 1, 1997 at 1, available in 1997 WL 8300101.

5. See Adler, *supra* note 3, at 1.

6. See Schwarcz, *supra* note 1, at 519 n.1.

7. See *id.*

cific pool of assets.⁸ “The process of issuing securities backed by assets in structured financing is sometimes called ‘securitization’ because assets are . . . turned into securities — they are monetized, not through traditional secured borrowing or factoring, but through the issuance of asset-backed securities.”⁹ Securitization allows for the transfer of assets, whereby the new asset holder receives payments of income from a separate legal entity.¹⁰ The separate legal entity in turn issues securities.¹¹ The payments to the asset holder are dependent upon the payments received by the assets and this structure securitizes the assets.¹²

An advantage of asset-backed securities is that they may offer the safety of triple-A rated securities,¹³ without the prepayment rights associated with mortgage-backed securities. Asset-backed securities may be structured so that they either have a fixed or a floating interest rate¹⁴ and they may be purchased by any investor licensed to trade treasury securities.¹⁵ They present an opportunity for the asset holder to acquire greater amounts of cash¹⁶ for less expense than commercial bank loans.¹⁷

In a typical transaction the assets are isolated from the originator¹⁸ and valued. A special purpose vehicle¹⁹ (hereinafter referred to as an

8. See Simon Hamer, *Others Queue Up to Launch Asset Backs*, GLOBAL PRIVATE BANKING, Apr. 14, 1997, at 12, available in LEXIS, Banking Library, CURNWS File. A relatively new financial creation, the first publicly offered asset-backed security transaction occurred in March, 1985. Sperry Lease Finance Corporation issued \$192.5 million of its series A lease-backed notes. See American Bar Association Section of Taxation, Committee on Financial Transactions, Subcommittee on Asset Securitization, *Legislative Proposal to Expand the REMIC Provisions of the Code to Include Nonmortgage Assets*, 46 TAX L. REV. 299, 343 n.160 (1991).

9. The Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, *Structured Financing Techniques*, 50 BUS. LAW. 527, 531-532 (1995).

10. See Malcolm S. Dorris & Edward J. O’Connell, *Problem Cases in Bankruptcy*, in NEW DEVS. IN SECURITIZATION 99, 101 (PLI Commercial Practice Course Handbook Series No. A-732, 1995).

11. See *id.*

12. See *id.*

13. See Schwarcz, *supra* note 1, at 521 n.15.

14. See Hamer, *supra* note 8, at 12.

15. See Simon Hamer, *Product Focus Bowie Bonds*, OPERATIONS MGMT., Mar. 24, 1997, at 10, available in LEXIS, Banking Library, CURNWS File.

16. See Adler, *supra* note 3, at 5.

17. See Dorris & O’Connell, *supra* note 10, at 102.

18. The entity that owns the assets before the securitization is called the originator. See Schwarcz, *supra* note 1, at 519.

19. A special purpose vehicle may be either a trust, a corporation or a limited liability partnership which is created for the sole purpose of isolating the assets from the originator. See Dorris & O’Connell, *supra* note 10, at 105. See also Marsha E. Simms, *Asset Securitization*, in ASSET-

“SPV”) is created and the assets are transferred to the SPV in the form of a true sale. Asset-backed securities are issued,²⁰ and a servicer for the SPV’s assets is established.²¹ Each of these steps will be discussed in more detail in part VI, A - E.

Asset-backed securities are an increasingly prevalent vehicle for financing business enterprises, and have grown steadily as a form of financing, especially in recent years. In 1995, \$119 billion²² in asset-backed securities were offered. This expanded to \$148 billion in 1996,²³ and increased to an overwhelming \$185.1 billion in 1997.²⁴ Analysts forecast that this number will continue to increase, and predict that around \$200 billion in asset-backed securities will be offered in 1998.²⁵

Because of the dramatic growth in new financial products, including asset-backed securities, the Securities Exchange Commission (hereinafter referred to as the “SEC”) has created a new office to handle the products.²⁶ Additionally, the SEC plans to publish asset-backed registration forms to accommodate the regulation of these complex legal and financial structures, creations which pose difficulties for regulators, lawyers, and issuers.²⁷ More poignantly, the SEC’s division of corporate finance is constructing departments especially for media and high technology companies.²⁸ The actions taken by the SEC indicate that these financing vehicles are not merely a passing trend: the SEC is planning for the future and is responding to market demand.

BASED FINANCING 335, 338-341 (PLI Commercial Law and Practice Course Handbook Series No. A4-4518, 1997).

20. See Schwarcz, *supra* note 1, at 517 n.1.

21. See The Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, *supra* note 9, at 548.

22. See Aaron Elstein, *Issuance of Asset-Backed Securities Jumped to a Record \$148 B in Year*, AM. BANKER, Dec. 30, 1996, at 28.

23. See *id.*

24. See Karen Talley, *'97 Asset-Backed Issues a Record \$185B*, AM. BANKER, Jan. 23, 1998, at 22.

25. See *id.*

26. See Steven Goldstein, *SEC Creates New Group to Handle ABS, New Products*, CORPORATE FINANCING WEEK, Dec. 15, 1997, at 1, available in LEXIS, News Library, CURNWS File. The new group is headed by Barry Summer. See *DC Wrap Up*, CORP. FINANCING WK., Mar. 30, 1998, at 9, available in LEXIS, News Library, CURNWS File.

27. See *id.*

28. See *id.*

III. DAVID BOWIE: THE MAN WHO RETAINED THE WORLD — IN THE OWNERSHIP OF HIS COPYRIGHTS

David Bowie has been performing and recording music since the 1960s.²⁹ In late 1997 he was identified as having the highest net worth of any musical entertainer in Britain, an estimated 550 million pounds.³⁰ Bowie has collaborated and performed with legends such as Bing Crosby³¹ and John Lennon.³² Most recently, he worked with Trent Resnor of Nine Inch Nails.³³ However, for most of his career Bowie has performed individually, rather than collaborating with a band.³⁴ As a result, he is usually the sole composer of the music he has records and performs.³⁵ This means, as the author, he is the sole copyright owner of the musical compositions.³⁶

Unlike many other recording artists, Bowie has retained ownership of the record masters and copyrights to the majority of his back catalog of music,³⁷ some of which dates back to the 1960s.³⁸ Frequently

29. Although he has performed under a variety of names, his first release as David Bowie was in 1971. See DAVID BOWIE, *THE MAN WHO SOLD THE WORLD* (Rykodisc 1971). See also <<http://www.davidbowie.com/freebowie/bowie/indexevol.html>> (visited Oct. 30, 1998) (discussing history and discography from the artist's own perspective). Also available at that page is BowieNet, an ISP launched in September of 1998. See *Ground Control to davidbowie.com*, AP ONLINE, Jul. 21, 1998, available in 1998 WL 6699482.

30. The net worth of each artist was calculated by examining company accounts, record sales, and other earnings over the past thirty-five years. The information was contained in a study conducted by *Business Age* magazine. See *Brit Pop Elite Net £ 38 Billion*, GLOBAL PRIVATE BANKING, Nov. 10, 1997, at 7, available in LEXIS, News Library, CURNWS File.

31. See DAVID BOWIE (WITH BING CROSBY), *Peace on Earth/Little Drummer . . . Boy*, on THE COOLEST CHRISTMAS (Oglio 1994). This single was originally seen and heard on a television Christmas special which was broadcast in the United States in the early 1970's. Thereafter it has been featured on a few Christmas compilations; the one listed above is still available as of the date of this comment.

32. See DAVID BOWIE, *YOUNG AMERICANS* (Rykodisc 1975).

33. See DAVID BOWIE, *EARTH LING* (Virgin Records America, Inc. 1996 & 1997).

34. See Sam Adler, *Bowie Breakthrough: Structuring Music Bonds*, ENT. L. & FIN., Sept. 1997, at 1, 7.

35. See *id.*

36. Under the Copyright Act of 1976, a Copyright owner "with respect to any one of the exclusive rights comprised in a copyright, refers to the owner of that particular right." 17 U.S.C. §101 (1994).

37. See Aaron Elstein, *If It Moves, David Pullman Might Securitize It*, AM. BANKER, Feb. 28, 1997, available in 1997 WL 4748003; Charles Pretzlik, *Ziggy Stardust Wows them on Wall Street*, THE DAILY TELEGRAPH (London), Feb. 5, 1997, available in 1997 WL 2282439; Jay Mathews, *Securities Oddity: The Bowie Bond*, THE WASH. POST, Feb. 6, 1997, at C1.

an artist loses control and/or ownership of his or her copyrights because the rights are assigned to a record company³⁹ and a music publisher.⁴⁰ Generally this occurs in the early stage of an artist's career when he or she has relatively little leverage in effectuating a recording or music publishing deal.

Because Bowie has retained the ownership of the copyrights to his musical compositions, he possesses the exclusive right:

to do and to authorize any of the following: (1) to reproduce the copyrighted work in copies or phonorecords; (2) to prepare derivative works based upon the copyrighted work; (3) to distribute copies or phonorecords of the copyrighted work to the public by sale or other transfer of ownership, or by rental, lease, or lending; (4) in the case of . . . musical . . . works . . . to perform the copyrighted work publicly; (5) in the case of . . . musical . . . works, . . . to display the copyrighted work publicly; and (6) in the case of sound recordings, to perform the copyrighted work publicly by means of a digital audio transmission.⁴¹

Each of these rights represents a potential stream of income. As with other property rights, copyrights are a bundle and may be divided, assigned, or licensed in any number of ways. The rights are routinely split and shared by the artist, the record company, and the music publisher.

A recording contract, at its most basic level, is an employment contract.⁴² An artist's works created under the terms of a recording contract, unless otherwise provided, belong to the record company.⁴³ Typically, the rights transferred by an artist to a record company in a recording contract include the rights to the sound recordings.⁴⁴ "Exclusive rights under the copyright in sound recordings are limited to reproduction, the preparation of derivative works, and distribution."⁴⁵ Traditionally, the right to publicly perform was not included in the

38. See Dominic Bencivenga, *Bowie Bonds Pioneer Deal Uses Copyrights to Raise Capital*, N.Y. L.J., May 15, 1997, at 5.

39. See SIDNEY SHEMEL & M. WILLIAM KRASILOVSKY, *THIS BUSINESS OF MUSIC* 10-11 (Paul Ackerman, ed., 4th ed. 1979).

40. See JEFFREY BRABEC & TODD BRABEC, *MUSIC, MONEY, AND SUCCESS* 11-15 (1994).

41. 17 U.S.C. § 106 (1994 & Supp. I 1995-1996).

42. See SHEMEL & KRASILOVSKY, *supra* note 39, at 10.

43. See *id.*

44. The Copyright Act of 1976 provides copyright protection for sound recordings. See 17 U.S.C. § 102(a)(7) (1994).

45. SHEMEL & KRASILOVSKY, *supra* note 39, at 11.

copyright to a sound recording.⁴⁶ In some instances, a record company may provide for the ownership interest in the copyrights and masters to revert to the artist.⁴⁷ This, however, is the exception, rather than the rule and generally applies to artists who possess star status or who have a proven track record and therefore more leverage when negotiating.⁴⁸

Music publishing contracts pertain to other rights possessed by the copyright owner of a musical composition. Songwriter-music publisher contracts appear in various formats, depending upon the publishing company involved.⁴⁹ An agreement may be made for a single song or may cover all material written by a songwriter for a term of years.⁵⁰ The contract for a term of years, also called an exclusive songwriter's contract, is generally reserved for writers who have demonstrated success, possess a recording contract or a possibility of a recording contract, or those who are thought to possess the requisite potential, as interpreted by the music publisher.⁵¹

As a general practice, a music publisher retains ownership of all the songs a writer transfers to it for the life of the copyright,⁵² without a reversion of the copyright to the songwriter at the end of the deal.⁵³ If the writer also has a major record contract or other leverage when negotiating the contract, a reversion clause may be inserted into the agreement, and the music publisher may sometimes retain the copyright only for a term of years.⁵⁴ This, however, is a rare occurrence.⁵⁵

Under a music publishing contract, in addition to achieving ownership of or a license to the composition, the publisher acquires the rights to: license performances of the composition; make or authorize derivative works of the composition; dramatize the music, title, and/or the lyric plot by granting synchronization licenses to television and

46. *See id.* But see 17 U.S.C. § 106(6) (Supp I 1995-1996). An exclusive right has been granted to the copyright owner of a sound recording: "to perform the copyrighted work publicly by means of a digital audio transmission." Exemptions to this right are set forth in 17 U.S.C. § 114(d)(1)-(4) (1994 & Supp. I 1995-1996).

47. *See* SHELLEY & KRASILOVSKY, *supra* note 39, at 11.

48. *See id.*

49. *See* BRABEC & BRABEC, *supra* note 40, at 13.

50. *See id.* at 11.

51. *See id.* at 11-12.

52. The duration of a copyright was increased by 20 years in the United States, in October of 1998. The duration of a copyright is now for the life of the author plus 70 years, rather than 50 years. *See Disney Led Push to Add 20 Years to Copyright*, L.A. TIMES, Oct. 18, 1998 at A18.

53. *See* BRABEC & BRABEC, *supra* note 40, at 14.

54. *See id.* at 14.

55. *See id.*

motion picture film producers; license the composition for compact disks and other commercial formats; print or license the composition in the form of sheet music and folios; license the title of the composition for use as a title of a dramatic work; exercise any and all rights to the composition existing currently or arising in the future; and negotiate the use of the composition in existing or future technology.⁵⁶

Bowie, in his fifties, was evidently motivated by estate planning interests when he entered this deal.⁵⁷ When he dies, his heirs would not necessarily need to translate his copyright assets into cash in order to pay the estate taxes.⁵⁸ Additionally, when the music catalogue passes to his heirs, the heirs are not taxed on the appreciation of the bond.⁵⁹

IV. I'M HAPPY, HOPE YOU'RE HAPPY TOO: THE BOWIE BONDS DEAL

To set the scene, Bowie's recording and distribution agreements were going to expire.⁶⁰ His business manager of the Rascoff Zysblat Organization, William Zysblat, investigated other financing options. Zysblat discussed an asset-backed bond issuance with David Pullman, the managing director of New York's Fahnestock & Company's structured asset sales group, and attorney Richard Rudder, head of the securitization practice at New York's Willkie, Farr & Gallagher. Pullman, Rudder, and Zysblat determined that an asset-backed bond issuance would be more beneficial to Bowie's interests than a traditional distribution agreement because it would afford him greater financial gains. As a result of this deal, Bowie received \$55 million.⁶¹

The bonds were issued at a fixed rate of 7.9 percent and have an average life of ten years, and reach maturity at fifteen years.⁶² The bonds were sold privately to Prudential Insurance Company.⁶³ Under

56. *See id.* at 15.

57. *See* Charles Pretzlik, *Ziggy Stardust Wows them on Wall Street*, THE DAILY TELEGRAPH (London), Feb. 5, 1997 available in 1997 WL 2282439; *Bowie Ch-Ch-Changes the Market*, CFO, THE MAG. FOR SENIOR FIN. EXECUTIVES, Apr. 1, 1997 available in 1997 WL 8300101.

58. *See* Adler, *supra* note 3, at 5.

59. *See id.*

60. *See* Bencivenga, *supra* note 38, at 5; Adler, *supra* note 34 at 6 (noting that all of Bowie's contracts were due to be renewed).

61. *See* Adler, *supra* note 34, at 6 (noting the gains could reach \$55 million).

62. *See* Adler, *supra* note 3, at 5.

63. *See* Jon Birger, *Will Bowie Banker Avoid Fall to Earth?: Pullman Gets His Calls to Stars Returned, But He Needs Deals to Fend Off the Critics*, CRAIN'S N.Y. BUS., Jul. 28, 1997, at 1, available in 1997 WL 8254445.

section 4(2) of the Securities Act of 1933,⁶⁴ selling the bonds privately eliminated numerous cumbersome reporting requirements.⁶⁵ Upon the maturity date of the bonds, the copyrights will revert back to Bowie, provided that all of the bond payments are made.⁶⁶ The lines of credit underlying the transaction were designed so that if the royalty payments decreased, the other credit lines would compensate and the periodic bond payments could be met.⁶⁷

The fact that Bowie retained the copyrights in his musical compositions was key in structuring the Bowie bonds deal, because the royalty income generated by the copyrights and received from music publishing licenses and record sales were the assets that backed the bonds.⁶⁸ In addition to the tax advantages, Bowie gained the greater present value of the royalty payments for investment purposes by receiving the cash before the periodic royalty payments would have been made to him. Additionally, the acquisition of the lump sum enabled him to easily diversify his income sources because he could make investments that would generate revenue beyond the music industry.

The predictability of an asset's income stream is another necessary piece of an asset-backed transaction. Bowie's recordings consist-

64. The Securities Act of 1933, 15 U.S.C. § 4 (2) (1994). The Securities Act of 1933 and the Securities Act of 1934 were enacted following the Great Depression. The Acts were designed to protect the public from fraudulent securities transactions and to provide relief where state "blue sky" laws had been ineffective. The Securities Act of 1933 governs an entity's initial offering of securities. Its purpose, in general, is to assure that reliable and adequate information is available pertaining to securities that are offered to the public. Under the Act, it is illegal to sell or offer securities to the public unless they have been registered with the Securities Exchange Commission. However, a private offering of securities is exempt from the registration and prospectus requirements. The Securities Act of 1934 primarily pertains to disclosure and reporting requirements of corporations that have publicly-held securities that are outstanding. See RICHARD T. McDERMOTT, *LEGAL ASPECTS OF CORPORATE FINANCE* 12-13 (1985).

65. There are some important exemptions to the Act, one of which is contained in § 4(2) which provides that "transactions by an issuer not involving any public offering" need not be registered. 15 U.S.C. § 4(2) (1994). Not surprisingly, enormous amounts of securities have been sold privately under this exemption. For example, in 1983, \$4 billion of securities were sold privately. See RICHARD T. McDERMOTT, *LEGAL ASPECTS OF CORPORATE FINANCE* 14 (1985). See also Rebecca A. Byam, *Financing a Small Business*, in REPRESENTING THE SMALL BUS. 189, 203 (PLI CORP. L. & PRAC. COURSE HANDBOOK SERIES, 1992) (stating that such transactions are also limited to the issuing company and that small companies find that the greater reporting requirements imposed on public companies make public offerings a less efficient means of attracting seed capital when, as a private company, financing can be rapidly arranged without approaching all shareholders, and reporting to the Securities Exchange Commission is not necessary).

66. See Adler, *supra* note 34, at 1.

67. See Adler, *supra* note 3, at 1. An additional guarantee was made by EMI Music, David Bowie's record distributor. See *Bowie Ch-Ch-Changes the Market*, *supra* note 4.

68. See Sam Adler, *Bowie Bond Buyer Explains Investment*, ENT. L. & FIN., SEPT. 1997, at 6.

tently sell at the rate of one million compact disks and cassettes, albums and singles, on the world market per year.⁶⁹ His catalog of musical compositions has existed for years, providing a well documented performance record.⁷⁰

EMI's fifteen year licensing deal for Bowie's back catalog of approximately 250 compositions⁷¹ was used as credit enhancement.⁷² After fifteen years, the ownership of the master tapes reverts back to Bowie, assuming that all of the bond payments are made.⁷³ EMI benefited from the transaction also. Prior to the expiration of Bowie's contract, EMI had the international rights and Rykodisc held the rights in the Northern American territory.⁷⁴ Now, EMI has both the domestic and the international rights to Bowie's existing back catalog⁷⁵ and for \$30 million, EMI acquired the right to distribute Bowie's future releases not backing the bonds.⁷⁶

Pullman, who was responsible for organizing the deal, views such asset-backed transactions as a unique alternative to traditional bank loans because they generate more capital and may either have a fixed or a floating interest rate.⁷⁷ Additionally, banks usually will require personal guarantees and loan money based on the liquid assets of a borrower.⁷⁸ Copyrights and other property interests only become liquid once they are assigned, so the assets on which a bank or other commercial lending institution would structure a loan would not accurately reflect Bowie's worth. A bank would not consider his other property, including his rights to receive periodic royalty income from his copyrights. Also, it would not be a wise business decision to sell Bowie's music copyrights because of the devastating tax ramifications that

69. See Mathews, *supra* note 37, at C1.

70. See Adler, *supra* note 68, at 6.

71. See Bowie *Ch-Ch-Changes the Market*, *supra* note 4.

72. See Adler, *supra* note 68, at 6. See also *infra* Part VI, D (1) - (3).

73. See Adler, *supra* note 34, at 6. It is likely that the property rights in the master recordings technically revert back to Bowie's SPV, rather than to Bowie, the originator. If the property rights were to revert back to Bowie himself, there may be consolidation concerns under federal bankruptcy law and piercing the corporate veil concerns under state corporations law. See *infra* VI, C.

74. See *Pru Bonds with Bowie to the Tune of \$55M*, STAR LEDGER SPOTLIGHT (1998) (visited Oct. 27, 1998) <<http://www.nj.com/spotlight/bowie/bowiebus.html>>.

75. See Adler, *supra* note 3, at 6.

76. See *Pru Bonds with Bowie to the Tune of \$55M*, STAR LEDGER SPOTLIGHT (1998) (visited Oct. 27, 1998) <<http://www.nj.com/spotlight/bowie/bowiebus.html>>.

77. See Hamer, *supra* note 8, at 12.

78. See Adler, *supra* note 3, at 1.

would be incurred under a sale.⁷⁹ If the catalogue was sold for \$50 million, half of that amount would be paid in taxes.⁸⁰ Bonds are preferable to a sale of copyrights also because the revenue from the licensing of such rights generally increases over time due to an ever-expanding market.⁸¹ Furthermore, by holding onto the copyrights as long as possible, Bowie and/or his heirs would be able to benefit from that market, provided that all of the bond payments are made.

As with any transaction, there is some element of risk which deters certain categories of investors. Generally, the most amenable investor for this sort of a transaction is a "buy and hold" investor, an investor that can afford to reap the benefits of an investment over a longer period of time, as opposed to benefiting from short-term market gains.⁸² Entertainers come and go,⁸³ but with the proper structure, the risks inherent in an asset-based transaction can be effectively managed and minimized.

V. FROM MUSIC TO MICROCHIPS: THIS FINANCING VEHICLE'S MULTIFARIOUS APPLICATIONS

As indicated above, since the Bowie bonds were sold privately, SEC registration was not required, and accordingly, a prospectus was not issued.⁸⁴ As a result, there is limited information publicly available about the construction of that particular securities transaction. It is known, however that a number of other investment banking firms do structure securities based on entertainment royalties, including Pru-

79. *See id.* at 5.

80. *See id.* An in-depth analysis of the legal tax issues surrounding the securitization of assets is beyond the scope of this comment.

81. *See id.* *See also infra* Part VI (A)(2) where examples of the ever-expanding market are indicated.

82. Prudential Investments, the purchaser of the Bowie bonds, is characterized by its vice president of structured finance, Andrea Kutscher, as a buy and hold investor. *See Adler, supra* note 68, at 6.

83. *See Adler, supra* note 3, at 6. (quoting Duane Smith, chief of the Goodyear Tire & Rubber Pension Plan). David Pullman's response to Smith's comment was that the deal was marketed to big insurance companies who buy asset-backed securities and not to pension plan managers. *See id.*

84. David Pullman was likely pleased with this outcome, as it initially prevented others from duplicating his work. *See Birger, supra* note 63. Pullman's company was contacted to ensure that the facts describing the Bowie bonds deal as stated in this comment are accurate. The company's representative, T. Chung, declined to comment. Hence, the facts contained herein are gathered from various sources including law and finance journals and articles, banking trade publications, newspapers, and magazine articles.

dential, Noruma, and Alliance of Canada.⁸⁵ It is evident that there is a process for the securitization of assets of any business enterprise⁸⁶ and since the Bowie bonds offering, copyright holders are taking advantage of it.

Songwriters, authors, film studios, and even sports organizations around the globe have explored the possibilities of asset-backed securitization. To date, the Motown songwriting team of Edward Holland, Lamont Dozier and Brian Holland, who are credited with such compositions as "Stop! In the Name of Love," have also benefited from the securitization of the future receivable royalties from the copyrights of their songs to the tune of \$30 million.⁸⁷ However, unlike the Bowie bonds, the Motown songwriting trio's deal was not guaranteed by a record company.⁸⁸ Yet another deal was closed between singer-songwriter Rod Stewart and Nomura Asset Capital whereby a \$15.4 million loan was secured against the singer's future royalties.⁸⁹ Stewart's loan is expected to be bundled with other artists' loans and securitized in the future.⁹⁰ Additionally, the authors Tom Clancy⁹¹ and Toni Morrison have each entered into asset-backed deals.⁹²

85. Lionel Sobel, Editor, Entertainment Law Reporter, spoke at the American Bar Association's Annual Meeting Forum on the Entertainment and Sports Industries held October 16-17, 1998 at the Westin River North Hotel in Chicago, IL. Sobel answered a question as to what other firms are issuing asset-backed entertainment bonds. Since the Bowie bonds deal, Prudential Investments, a division of Prudential Insurance Company of America, has entered into a venture to securitize music royalties with RZO, Joseph Rascoff's and William Zysblat's music management company. The new venture is called Entertainment Finance International, LLC ("EFI"). Prudential Investments, the holder of the Bowie bonds, will have a "first look" at any new deals formulated by EFI. This venture arose just months after another division of Prudential Insurance Company, Prudential Securities, formed CAK Universal Credit Corporation with Charles Koppelman, a music executive. See *Some Royal Competition*, ASSET SALES REPORT, Apr. 20, 1998 at 1, available in 1998 WL 5130128.

86. See generally Meredith S. Jackson, *Leap of Faith: Asset-Based Lending to Asset-Backed Securitization: A Case Study*, 2 STAN. J.L. BUS. & FIN. 193 (1995) (describing asset securitization as a possible low-cost form of financing for an asset-based lender which derives profits from commercial loan receivables).

87. See Ross A. Snel, *New 'Bowie' Bonds Bank on Royalties from Motown Trio*, WALL ST. J., Apr. 29, 1998, at C22; Andy Serwer, *A Sequel to Bowie Bonds: Supreme Securities*, FORTUNE, Jun. 8, 1998. This deal resulted in a \$30 million private placement of future royalties-backed securities for the songwriters. The transaction was formed based on the writers' shares of income and was built around three separate deals. See *Bit Parts*, ENT. L. & FIN., Aug. 1998.

88. See Snel, *supra* note 87, at C22.

89. See *id.*; Michael Dumiak, *Rock and Roll? I Love It*, PRIVATE PLACEMENT REP., Sept. 28, 1998, at 1, available in 1998 WL 5035085.

90. See Snel, *supra* note 87, at C22.

91. See Hamer, *supra* note 8, at 12. Tom Clancy was a likely candidate for utilizing the option of asset-backed financing because he has authored a large number of best-selling books. The

Asset-backed securities have also sprung forth as a revenue raising avenue for film companies and the issuances are occurring worldwide. These financial structures have even been backed by potential assets: the future revenues of films which have not yet been produced.⁹³ As early as 1996, Twentieth Century Fox raised U.S. \$1 billion by issuing bonds backed by the future film revenues.⁹⁴ Other film companies soon followed suit.⁹⁵ Dreamworks SKG has also struck a deal based on potential revenues from future film releases.⁹⁶ Additionally, PolyGram, a Dutch entertainment group, generated \$650 million by selling bonds backed by cash flows from films it will produce over the next three years.⁹⁷ That company's production schedule includes a film starring the actors, Julia Roberts and Hugh Grant.⁹⁸ In Italy, \$300 million in bonds backed by the revenues of Italian film library Cecchi Gori were recently issued.⁹⁹

Asset-backed securities as a viable financing model have even permeated the world of sports. The management of England's Newcastle United Football Club envisions the securitization of prospective stadium ticket and merchandise sales.¹⁰⁰ This concept for the financing of sports teams also rose in Italy, where the fervor for asset-backed funding is driven by the cries of star soccer players for higher contract salaries.¹⁰¹ Closer to home, Ascent Entertainment, the owner of Denver's NBA and NHL franchises, will issue \$130 million in asset-

consistency of the sales of the books, and the revenue stemming from the sales, are key factors in securitizing the future receivable royalties of an author.

92. See James Surowiecki, *Gold into Led*, WIRE, Sept. 1998, at 77.

93. See Simon Davies, *PolyGram Bond Issue to Raise \$650M*, FIN. TIMES., Apr. 17, 1998, at 1, available in 1998 WL 3547683.

94. See Surowiecki, *supra* note 92, at 77 (discussing the likelihood of the issuing of bonds backed by the revenues generated from a single film and the potential of volatility which would accompany such an issuance).

95. See *id.*

96. See Patrick McGeehan, *Rock 'n' Roll Bonds Tap Investors' Faith in Future Royalties: Bowie Issue Sold Out Quickly but the Market's Appetite Remains Hard to Measure*, WALL ST. J., Feb. 10, 1998, at B10.

97. See Davies, *supra* note 93, at 1.

98. See *id.*

99. See Andy Serwer, *Street Life: A Sequel to Bowie Bonds: Supreme Securities*, FORTUNE, June 8, 1998, available in 1998 WL 2501359.

100. See Aaron Elstein, *Soccer Team May Securitize Unsold Tickets*, AM. BANKER, May 28, 1997, at 26.

101. See *id.*

backed securities to raise funds for the Pepsi Center Arena it plans to build.¹⁰²

As with any financing method, the potential for market volatility is always a concern. The "crash" of the Led Zeppelin bonds (ESX:LZEP) in September of 1998 led to some speculation as to whether or not the "culture bond" market would hold.¹⁰³ It was reported that the "crash" was the result of the collapse of the Asian demand for classic rock.¹⁰⁴ However, it is likely that several factors, not just one, contributed to the collapse of that bond deal. For this reason the Bowie bonds deal and other deals were structured by using revenues generated by the world market, and other assurances for investors including adequate credit enhancements that are designed to kick in if and when an income stream evaporates. Not surprisingly, despite concerns surrounding the Led Zeppelin bonds issuance, deals continue to be written.

High technology businesses, like other businesses, require ready capital not only to operate, but for the research and development of products. It is estimated that the average cost of development of a product in the high technology arena is ten times the cost of invention.¹⁰⁵ Many high technology companies sell debt instruments, such as bonds, which are convertible to future equity in the form of stock.¹⁰⁶ Nevertheless, an asset-backed securitization of the revenues derived from copyrights, patents, and other intellectual property rights may be an appropriate financing vehicle for some high technology companies.

VI. IT'S ALL A VAST CREATION: STRUCTURING AN ASSET-BACKED SECURITIZATION

There are at least five steps in structuring an asset-backed securities transaction. The steps are not necessarily sequential; they may be simultaneous. The assets are identified and valued. A SPV is formed and the assets are transferred from the originator to the SPV. Some form of credit enhancement for the asset-backed securities is usually required in order for the securities to achieve a higher investment rating

102. See Luke Cyphers, *Fancy Financing in Yanks' Future?*, N.Y. DAILY NEWS, April 27, 1998, at 1, available in 1998 WL 11031136.

103. See Surowiecki, *supra* note 92, at 77.

104. See *id.*

105. See *An Economic Analysis of Royalty Terms in Patent Licenses*, 67 MINN. L. REV. 1198, 1230 (1983).

106. See Carol Haber, *IP Bond Plan Draws Interest of High Tech*, ELECTRONIC NEWS, May 5, 1997, available in 1997 WL 8580182.

by a rating service and thereby attract investors. Additionally, if the purchaser is an institutional investor and has internal policies and safeguards that dictate its investment practices, credit enhancement may be a prerequisite to the purchase of the securities. After credit enhancement is assured, the asset-backed securities are issued. Finally, a form of servicing the assets and paying the bond holders is established.

A. *Break Open Your Million Dollar Weapon:
The Identification and Valuation of the Assets*

1. General Considerations

The first step in an asset-backed securities transaction is to identify the assets to fund the transaction.¹⁰⁷ There should be a steady stream of income from the assets which should be sufficient to cover the distribution of income to the asset-backed securities, the administrative expenses, and the default risk for the whole portfolio.¹⁰⁸ In addition, the assets must be clearly identifiable and severable from the other assets of the originator. This is crucial if the originator retains the role of servicing and collecting the receivables because it further insulates the originator from risk upon completion of the transaction. Also important in the identification process of any asset or receivables is a determination of the regularity that payments are disbursed.¹⁰⁹ If the payments on the assets are predictable, the assets may be valued at a higher rate.¹¹⁰ The predictability of the aggregate rate of default is also a factor in valuing the assets.¹¹¹ If the default rate is predictable, then receivables that present some risk of default may also be securitized.¹¹² A factor to consider when determining the default rate is whether the pool of receivables is due from many obligors or merely one source.¹¹³ A pool from many obligors is preferable because it diversifies the risk inherent in an asset-backed bond issuance.

107. See Schwarcz, *supra* note 1, at 519.

108. See The Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, *supra* note 9, at 532 (stating that any asset providing a predictable stream of income or that can be converted into a predictable amount of cash can be securitized).

109. See Schwarcz, *supra* note 1, at 519.

110. See G. Larry Engel & Andrew B. Koslow, *Securitization Advice for Asset-Based Lenders*, in *ASSET BASED FINANCING 1995*, at 471, 474-475 (PLI Commercial Law & Practice Course Handbook Series No. A-708, 1995).

111. See Schwarcz, *supra* note 1, at 519.

112. See *id.*

113. See *id.*

2. Sound of Gold: Bowie's Streams of Income

With regard to the Bowie bonds transaction, the royalties used to back the bonds were from his musical compositions written and recorded prior to 1993.¹¹⁴ The income generated from the royalties was predictable.¹¹⁵ The titles to the copyrights were traced and there were no outstanding disputes because the royalty checks were issued and delivered to the same address for thirty years.¹¹⁶

Additionally, some of the risks inherent in the royalty revenue-backed bond issuance are effectively managed because the income is not dependent on merely one source: the market is world-wide.¹¹⁷ Also notable is that in addition to having a diverse geographic market, the royalties also may be collected from the licenses of any number of uses of the copyrighted sound recordings and the musical compositions. Specifically, music may generate royalty revenue from: air play on analog AM/FM radio stations; air play on webcast stations; sales of copies of sound recordings; use in computer and video games; use on web pages; film synchronization uses; on-hold office music; and even advertising. Bowie's sound recordings and compositions have been utilized in some of these ways. Recently, Microsoft Corporation used Bowie's song *Heroes*¹¹⁸ in a television advertising campaign. A version of *Heroes*, performed by The Wallflowers, appeared on the soundtrack compilation album for the film *Godzilla*.¹¹⁹

Aside from use, revenues are also derived from sales. An artist such as Bowie is of interest to the public as a phenomenon or entity; this interest will not necessarily be disturbed in the event of his death. Such an occurrence, as morbid as it might seem, would probably yield higher sales and thus, greater profits. Music is collectible and a product consumers might buy twice, for example, if a song is re-mixed by a named producer or rereleased with previously unreleased tracks.

In addition to the traditional means of exploiting a copyrighted work, there are expanding markets for the use of music and other copyrighted works due to emerging technologies.¹²⁰ Technology has in

114. See Mathews, *supra* note 37, at C1.

115. See *id.*

116. See Adler, *supra* note 34, at 7.

117. See Mathews, *supra* note 37, at C1.

118. DAVID BOWIE, *Heroes*, on HEROES (Rykodisc U.S.A. 1977).

119. THE WALLFLOWERS, *Heroes*, on GODZILLA (Sony Music 1998).

120. The Internet poses great difficulties for copyright enforcement but also great potential as a new market for copyrighted works, provided encryption and tracking technologies are successfully utilized. On a separate issue, under 17 U.S.C. § 114(d)(1)-(4) (1994 & Supp. I 1995-1996)

the past been a means for artists, record companies, and music publishing companies to profit. When compact disks reached the market, the sound quality had greatly improved so that worldwide many people replaced their vinyl warped record collections with compact discs. The digital remastering of old classics and popular music paved new profit avenues for the sound recordings and compositions gathering dust in the back catalogs of record companies and music publishers. It is only a matter of time before the new technologies currently intriguing lawyers and law students are harnessed and herded so that lost profits galloping through cyberspace may be realized.

3. Transition — Transmission: Application to the High Technology Industry

The intellectual property of a high technology company may take many forms including patents, copyrights, trade secrets, trademarks, trade dress, trade names, and service marks. A company may possess any one or all of these property rights in connection with a technology. The licenses to technology and incomes may derive revenues from a single intellectual property right, for example a patent, or from overlapping property rights. For instance, a product with a registered copyright on a portion of computer code, a patent, and a strong trademark associated with it so that it is immediately identifiable by consumers as a source indicator, holds at least three severable intellectual property rights. This comment is limited to an examination of how securitization might be beneficial for a patent holder.

In the high technology industry, a patent holder is perhaps the strongest and most certain protection available to intellectual property owners, a limited duration monopoly that is granted by the government. The Constitution provides Congress with the power to enact legislation to promote the useful arts and sciences.¹²¹ Under this authority, Con-

sound recordings are afforded a performance right that applies specifically to digital audio transmissions. This right allows record companies to recoup royalties from digital broadcasts (i.e. "webcasts"). A performance right for sound recordings does not exist for traditional analog broadcasts. In the initial form of section 114, there were certain exemptions carved out which related more or less to the degree of interaction or manipulation by the listener and the commercial benefits gained by the webcaster. Recently, changes applying to digital transmissions have been passed by Congress. The changes address the circumstances when a performance royalty is to be paid to record companies and the amount to be paid for sound recordings. These specific changes are not yet effective as of the date of this comment's publication. See <http://www.riaa.com/legal_frame.htm##_top> (visited October 30, 1998) and <<http://www.mp3.com/news/066.html>> (visited October 30, 1998) for commentary from the perspectives of both the Recording Industry Association of America and webcasters.

121. See U.S. CONST. art. I, § 8, cl. 8.

gress enacted statutes, including the Patent Statute, so that information would be more readily disseminated through the disclosure of inventions, and inventive activity would be protected but promoted. As an incentive for an inventor to disclose the exact nature of his or her inventive activity, a patent grants the inventor an exclusive right to a "new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof"¹²² for a limited period of time.¹²³ The rights granted to the patent holder enable the holder the right to "exclude others from making, using, . . . or selling [an] invention."¹²⁴ This can be extremely valuable for a patent holder, provided there is market demand for the invention which is protected by the patent.¹²⁵

Patent licensing presents an interesting dilemma when viewed as a prospective asset for securitization. It may be more beneficial for a patent holder to license the patent early in the research and development process because of the high cost of financing the process. If a patent is licensed in the early stages of development, the monies received from the licensing will help further develop and commercialize the product so that it reaches the market in a shorter period of time.¹²⁶ Generally, smaller companies are more likely to license patents early because they have less resources to devote to research and development than large companies.¹²⁷

Licensing a patent early in the development stage may be problematic due to the difficulty of assessing a product's true value.¹²⁸ For example, the product's true value may be affected by the uncertainty of patent validity or unanticipated market acceptance, resulting in greater valuation.¹²⁹ Thus, creativity and flexibility are often required when designing and structuring royalty schemes so that both the present and future value of the patented product can be realized by the patent holder. However, even if royalty schemes are drafted with great care,

122. 35 U.S.C. § 101 (1994). See 35 U.S.C. § 154(a)(1)(1994).

123. See 35 U.S.C. § 154(a)(2) (1994).

124. 35 U.S.C. § 154(a)(1) (1994).

125. See *An Economic Analysis of Royalty Terms in Patent Licenses*, 67 MINN. L. REV. 1198, n.5 (1983).

126. See *id.* at 1231-32.

127. See *id.* at 1233.

128. See *id.* at 1199.

129. See *id.* at 1199 n.196. Patent challenges and the determination of patent validity or invalidity and how that determination may affect the securitization of assets is beyond the scope of this comment. However, those issues would probably be analyzed during the rating of the securities.

such schemes may be miscalculated so that when a patented product reaches the market it is undervalued. If subsequently the royalty payments for the license of that patented product are used as security against a bond, it may be an insufficient use of the company's assets because the product has the potential to be licensed at a higher royalty rate upon the expiration of the licensing agreement. This difficulty may be solved by drafting. A provision may be included which allows for greater royalty payments to the bond holder(s) in the event that the patented item is licensed at a higher rate.

a. An Individual Inventor-Patent Holder

An individual inventor who has retained ownership in his or her patents, would be in a substantially similar position to David Bowie when structuring an asset-backed securitization transaction, provided that the patent was successful on the market and the income from the patent licenses was consistent, large, and predictable. In the event that an individual client fits the profile, asset-backed securitization may be the perfect means for acquiring ready capital for the future endeavors of a client-inventor.

Notably, finding an individual, rather than a company, who owns a back catalogue of patents is rare in the current marketplace because of the high cost of research, design, and fabrication. For this reason, generally a company funds the inventive activity and enters into a contract with an inventor whereby the inventor patent holder assigns the property rights to the patent to the company funding the project once the invention is completed. However, the California labor code contains provisions specifically relating to the inventive activity of employees. The relevant sections of the code allow in certain circumstances, an inventor to retain ownership of his or her inventive activity even when he or she is an employee and even if an assignment agreement is in effect.¹³⁰ Due to these provisions, it may be possible to have an individual client-inventor who meets the specifications required by financiers to construct a bond issuance.

As noted previously in the comment, Bowie had estate planning interests when entering this transaction. An individual who is a patent holder would undoubtedly have similar concerns. This aspect of the deal is distinguishable from the application of this financing vehicle to

130. See CAL. LAB. CODE § 2860 (West 1989); CAL. LAB. CODE §§ 2870-2872 (West 1989 & Supp. 1998); CAL. BUS. & PROF. CODE § 16600 (West 1997). See generally HOWARD C. ANAWALT & ELIZABETH F. ENAYATI, *IP STRATEGY: COMPLETE INTELLECTUAL PROPERTY PLANNING, ACCESS, AND PROTECTION* (1998).

a corporate patent holder. An individual may develop an estate plan with certain tax advantages. Such advantages will run during the course of his or her lifetime and it is likely that the benefits may be drafted and arranged to continue for the benefit of his or her heirs, in the event of the patent holder's death. It is apparent that a corporation is legally treated as a person for most purposes, but only a human being may take advantage of estate planning due to the fact that a corporation survives the expiration of its promoters, directors, officers, and shareholders.

b. The Patent Portfolio of a Large High Technology Company

A large high technology company has assets, many of which are intellectual property: copyrights, trademarks, patents, and licensing agreements.¹³¹ If a company has a patent, its value partially stems from the ability to ensure a legally-backed and enforceable monopoly on a portion of a particular market.¹³² By doing this, a company itself may profit from the manufacture, distribution, and sale of a physical product where the product is the fabrication of the intellectual property, the patent.¹³³ This situation, where the assets are receivables from sales profits, is akin to the Bowie bonds securitization, where the assets partially backing the transaction were periodic royalty payment receivables generated from the sales of copies of the sound recordings and the uses of musical compositions.

Additionally, a company may choose to license the use of or assign some or all of its intellectual property to another entity and receive periodic payments under that agreement. High technology companies generally license the use of MIPS¹³⁴ and ARM¹³⁵ microprocessor architectures and processor cores and royalties are generated from the license.¹³⁶ Such a situation is analogous to the music publishing portion

131. See Haber, *supra* note 106, at 1.

132. See generally *An Economic Analysis of Royalty Terms in Patent Licenses*, 67 MINN. L. REV. 1198 (1983).

133. See Haber, *supra* note 106, at 1.

134. MIPS is an acronym for "millions of instructions per second," a description for the speed of microprocessors.

135. ARM is an acronym for Advanced RISC Machines and is a company that manufactures technologies for the telecommunications industry for use in such products as personal digital assistants, smart phones, set top boxes, network computers, screen telephones, and digital cameras. See *ARM Introduces High Performance, Embedded Modem Solutions*, M2 PRESSWIRE, Jun. 9, 1997 at 1, available in LEXIS, News Library, CURNWS File.

136. See Haber, *supra* note 106, at 93.

of the Bowie bonds deal because the assets would be in the form of periodic royalty payments.

An interesting factor in applying asset-backed securitization to the high technology realm is that it requires a constant, stable, predictable, and manageable cash flow. It is a bit of an oxymoron to apply these elements to an industry that is always changing, improving, designing, refining and *replacing* products. There are at least three ways of managing this difficulty. One is to structure the deal so that it matures in a shorter time frame. In some areas, research and development take such a painfully long time that it may be a number of years before a replacement for existing technology is on the market and accessible to consumers.¹³⁷ A second solution is to structure the transaction using receivables from products that are fairly stable. For example, certain software packages that do not change a great deal over time or component parts which are necessary at a very basic level in the manufacturing of a given product may be used. Third, it may also be possible, depending on the company, to construct a diversified asset portfolio that consists of the receivables from a variety of products. This would help to ensure that the risk of one income stream disappearing would not be fatal to the transaction.

c. Start-Up Companies

Seed capital is required by all high technology start-up companies. Generally, financing for start-up high technology companies is sown by incorporating the company and issuing stock to shareholders. Shareholders purchase shares, inspired by the prospect that the company will succeed and will eventually make a public offering.

While a small start-up company may be receptive to alternative financing vehicles, this is an asset-based transaction. A start-up company may have some assets to set this financing vehicle in motion, but financiers generally want an estimated seven figures plus of proven annual revenue in order to structure an asset-backed bond offering.¹³⁸ Similarly, the term start-up necessarily implies *new* and most investors desire a revenue stream that exists for a period of years so that the risk may be calculated. It is therefore unlikely that a start-up would be a good candidate for an asset-backed securities transaction.

137. A possible example of this is found in the biotechnology industry. Some pharmaceutical products endure years of testing before they are approved for consumer distribution and use.

138. See *Will Silicon Valley Yield ABS Fruit?*, ASSET SALES REP., Mar. 31, 1997, at 1, 6.

*B. I'm Looking for a Vehicle:
The Creation of a Special Purpose Vehicle*

Another initial step in the structuring of an asset-backed bond is to create a special purpose vehicle, which may be a corporation, a grantor trust or an owner trust, a limited liability company or any other legally created entity which may suit or achieve the objectives of the funding.¹³⁹ This SPV has the specific purpose of isolating a set of assets¹⁴⁰ and severing the assets from any risks associated with the originator.¹⁴¹ In order to achieve this, the assets are generally transferred in the form of a sale so that it is adequate under bankruptcy law to remove the assets from the originator's estate.¹⁴² This transfer is commonly referred to as a *true sale* and will be discussed further in part C, *infra*.

In most securitization transactions, a SPV is created for a particular originator and a particular transaction.¹⁴³ A corporation is frequently used as a SPV because it is a somewhat flexible entity and its certificate and charter documents may contain provisions limiting its business activities to those necessary or incidental to the financing.¹⁴⁴ Also, participants in structured financing are generally familiar with how a corporation will be treated in bankruptcy and how corporate governance issues will be resolved.¹⁴⁵ Both factors are helpful when parties assess the legal risks of a structure.¹⁴⁶ Although such provisions are limiting, the SPV/corporation may issue securities if such an issuance is necessary to the SPV/corporation's purpose.

A corporation, however, may not always be a suitable SPV due to the tax ramifications of this entity type.¹⁴⁷ A corporation is subject to a separate corporate level taxation, which could result in a higher overall taxation at the state and local levels if the SPV is consolidated with the

139. See Marsha E. Simms, *Asset Securitization*, in *ASSET-BASED FINANCING 1997*, 335, 338-341 (PLI Commercial Law and Practice Course Handbook Series No. A4-4518, 1997).

140. See Jackson, *supra* note 86 at 197.

141. See Schwarcz, *supra* note 1, at 519.

142. See *id.*

143. See *id.* at 522.

144. See *id.* at 519. See also The Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, *supra* note 9, at 554.

145. See The Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, *supra* note 9, at 569.

146. See *id.*

147. See The Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, *supra* note 9, at 569-70.

originator for tax purposes.¹⁴⁸ However, if the SPV is owned by a third-party and cannot be consolidated for tax purposes with the originator, the transaction may be designed to minimize income tax by matching the income and expenses of the SPV as closely as possible.¹⁴⁹

The SPV may need to raise funds to purchase assets¹⁵⁰ for the financing. A SPV/corporation may issue several classes of securities¹⁵¹ in capital markets.¹⁵² In order to do this and to achieve the confidence of investors, the SPV needs to be constructed to make it "bankruptcy remote."¹⁵³ As bankruptcy remote, the SPV would not be vulnerable to the originator's creditors in the event that the originator becomes bankrupt. Commentators are quick to point out that bankruptcy remote does not mean bankruptcy proof.¹⁵⁴ Creating a bankruptcy remote SPV merely means that the SPV is less likely to be adversely affected by the originator's bankruptcy.

To ensure that a SPV is bankruptcy remote, rating agencies have set forth the following guidelines to be included in the SPV/ corporation's charter documents:

- (1) the activities of the SPV are limited to the particular securitization transaction and activities incidental thereto;
- (2) the SPV is prohibited from incurring any debt obligations other than the rated Securities unless: (a) the debt is rated the same as the Securities, (b) the debt is fully subordinate to the Securities and does not constitute a claim enforceable against the entity in a bankruptcy proceeding, or (c) the debt is nonrecourse and payable only from cash in excess of that required to make payments on the Securities, and, to the extent such excess cash flow is insufficient to pay the additional debt, that debt must not constitute a claim enforceable against the entity in a bankruptcy proceeding;
- (3) the SPV is prohibited from merging or consolidating with another entity unless the surviving entity is also subject to the same bankruptcy remote restrictions; and
- (4) without the vote of an inde-

148. *See id.*

149. *See* The Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, *supra* note 9, at 569-70.

150. *See* Schwarcz, *supra* note 1, at 519.

151. *See* Simms, *supra* note 139, at 338-341.

152. *See* JOHN DOWNES & JORDAN GOODMAN, *DICTIONARY OF FINANCE AND INVESTMENT TERMS* (3d ed. 1991) (defining capital markets as markets where capital funds — debt and equity — are traded. Included are private placement sources of debt and equity as well as organized markets and exchanges.)

153. *See* Schwarcz, *supra* note 1, at 519.

154. *See* The Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, *supra* note 9, at 584 (1995).

pendent party (i.e. a partner or director), the SPV may not: (a) file a bankruptcy or insolvency petition or otherwise initiate insolvency proceedings, (b) dissolve, liquidate, consolidate, merge or sell all or substantially all of its assets, (c) engage in any other business activity or (d) amend its organizational documents.¹⁵⁵

Limiting the amount of debt that may be incurred by the SPV/corporation limits the likelihood that the SPV would be involved in an involuntary bankruptcy proceeding because such an action may be commenced by three or more creditors holding non-contingent and unsecured claims exceeding \$10,000.00 in the aggregate amount.¹⁵⁶ These cautionary guidelines as set forth by rating agencies are intended to make the SPV's involvement in a bankruptcy proceeding highly unlikely.¹⁵⁷ The limitations set forth in the SPV/corporation's charter documents are intended to prevent creditors, besides the holders of the SPV's securities, from having claims which would permit the creditors to file an involuntary bankruptcy petition against the SPV.¹⁵⁸

Additionally, a corporation is flexible because it may be used for multiple sales of assets. Assets may be added to the corporation and additional securities issued as funding is needed or as assets accumulate.¹⁵⁹ As an additional benefit, because the specially-created corporation is a separate entity from the originator, the transaction will not appear as a debt on the originator's balance sheets.¹⁶⁰ Instead, the originator's balance sheets will show the residual equity piece it owns.¹⁶¹ This feature may appeal to an originator which is a large company, for example, a large high technology company, with annual report concerns.¹⁶²

In the Bowie bonds transaction, a special purpose corporation was employed.¹⁶³ Rudder, the attorney responsible for the legal portion of the transaction, stated that a key portion of the legal work involved the creation of a corporate structure to protect the assets from bankruptcy, estate problems, or third party creditors.¹⁶⁴ It is likely that

155. Dorris & O'Connell, *supra* note 10, at 106.

156. See The Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, *supra* note 9 at 557-558.

157. See Dorris & O'Connell, *supra* note 10, at 106.

158. See Schwarcz, *supra* note 1, at 519-520.

159. See Simms, *supra* note 139, at 344.

160. See Adler, *supra* note 3, at 6.

161. See *id.*

162. See Adler, *supra* note 34, at 7.

163. See Bencivenga, *supra* note 38, at 5.

164. See *id.*

familiarity with a corporation's treatment under bankruptcy law drove the decision to utilize a corporation as a SPV. The choice of a particular SPV is necessarily impacted by tax implications in addition to the ability to assess risks, such as the possibility of bankruptcy in a structured financing transaction. It is likely that Prudential Investments, the bond purchaser, and its structured financing personnel have some familiarity with corporate entities and that this familiarity provided a degree of comfort in working with the Bowie bonds structured financing model. Similarly, it is likely that a specially created corporation would translate readily to the high technology forum to serve as a SPV for an asset-backed transaction.

C. I Could Do with the Money:

A Sale of the Assets from the Originator to the SPV

1. Give a Little, Take a Little, Give a Little Back:
True Sale Treatment

Once the SPV is formed, the originator's isolated and valued assets are sold to the SPV. The Bankruptcy Code makes it imperative that this sale is a "true sale."¹⁶⁵ A true sale is a sale by the originator of its right, title, and interest in the asset which is to be securitized by the SPV.¹⁶⁶ The form of the sale of assets from the originator to the SPV is critical because it affects whether or not the SPV would be insulated in the event of the originator's bankruptcy.¹⁶⁷

If a true sale has not occurred, a court could hold that the transfer of assets was merely a financing transaction: a collateralized loan was made to the originator.¹⁶⁸ Under this characterization of the transaction, the transfer of assets is viewed as a pledge of collateral by the originator and in the event of his or her bankruptcy, the assets would be consolidated as part of the originator's estate under § 541 of the Bankruptcy Code.¹⁶⁹ The Equitable Doctrine of Substantial Consolidation grants the court the power in a bankruptcy proceeding involving "one or more related corporate entities to disregard the separateness of the corporate entities and to consolidate and pool the entities' assets and liabilities and to treat them as though held and incurred by one en-

165. See 11 U.S.C. § 541 (1994).

166. See Engel & Koslow, *supra* note 110, at 480.

167. See Jackson, *supra* note 86, 202.

168. See Dorris & O'Connell, *supra* note 10, at 107.

169. See *id.*

tity.”¹⁷⁰ Consequently, the formation of a separate corporation would be moot: the SPV may be exposed to liability and vulnerable to bankruptcy if the originator faces bankruptcy.¹⁷¹

Several factors are weighed when considering whether a true sale has occurred. These factors include: (1) whether the parties intended to engage in a true sale of the assets; (2) whether a transfer of the risks and benefits of the ownership of the assets has occurred; (3) whether the SPV and its investors bear the risk of loss if anything should happen to the assets; (4) whether the benefits of ownership appear to be retained by the originator because the originator may repurchase the assets by paying the purchase price; (5) whether the documentation provides that the originator services the transferred assets (which is customary, but may be done by an independent party); (6) whether the purchase price was fixed, as opposed to floating; and in some transactions, (7) whether there was compliance with the Uniform Commercial Code (hereinafter referred to as the “U.C.C.”).¹⁷² An important factor in the sales transaction is the extent to which the originator has “genuinely transferred the risks and benefits of ownership of the transferred asset.”¹⁷³ Additionally, the payment arrangements should not too closely resemble a commercial loan and prices should not be adjusted retroactively.¹⁷⁴

The dangers of consolidation assumed by investors in or purchasers of the asset-backed securities are as follows. If the originator files for bankruptcy and the court determines that a true sale has not occurred, the investor(s) in the asset-backed securities would be subject to the automatic stay provisions of the Bankruptcy Code. These provisions prevent anyone from filing a claim against a debtor’s property after the debtor has filed for bankruptcy.¹⁷⁵ At the very least, this would result in delays in the investors’ receipts of payments and at the very most, it could result in the investors’ loss of the entire investment.¹⁷⁶

170. Simms, *supra* note 139, at 350 (stating that consolidation affects asset-backed securitization by resulting in the originator and the SPV being consolidated).

171. See Jackson, *supra* note 86, 202.

172. See Engel & Koslow, *supra* note 110, at 481-85.

173. Jackson, *supra* note 86, at 202.

174. See Engel & Koslow, *supra* note 110, at 482.

175. See Dorris & O’Connell, *supra* note 10, at 105.

176. See *id.*

An originator could pass only the rights to receive periodic payments of royalties to a newly created SPV.¹⁷⁷ With this transfer of only the benefits of royalty payments, there is a danger of redefining a link from the originator to the SPV.¹⁷⁸ This link may then expose the originator to liability if royalty payments and credit enhancements fail.¹⁷⁹ If the SPV does not control the terms of the agreements, the originator may be viewed as funding the SPV. This defeats the purpose of creating the SPV in order to isolate the originator and insulate it from bankruptcy dangers.¹⁸⁰

It is apparent from the description above and was indicated by the attorney in the Bowie bonds transaction, with any financing, some control is lost over the assets.¹⁸¹ By tendering full payment of all of the obligations secured by collateral, the debtor can, however, establish a right of redemption of the debt instrument under the U.C.C.¹⁸² This is distinguishable from a right to repurchase the assets, whereby the transfer from the originator to the SPV may not be a sale.¹⁸³ The originator may maintain an option (not an obligation) to repurchase the assets from the SPV "once the aggregate principal amount of the assets has decreased to between five and ten percent of the original principal amount of the assets."¹⁸⁴ This will not jeopardize the true sale treatment of the transfer.¹⁸⁵ This option is usually exercised in securities transactions to avoid the high administration costs for a smaller transaction.¹⁸⁶

177. *See id.*

178. *See Jackson, supra note 86, at 200-201* (discussing the rights and obligations of a lending institution to its borrowers and the complexities of an asset-backed securities transaction in a revolving credit industry under U.C.C. §§ 9-318, 9-206 and 9-105 (1995), where an obligor may be interpreted as an "account debtor" for U.C.C. purposes if certain safeguards are not built into the transaction). The model incorporated by Ms. Jackson is based on a "credit card" model and is somewhat distinguishable from an asset-backed securities transaction in the high technology industry, that is, it is not piggy-backed lending per se.

179. *See Jackson, supra note 86, at 202.*

180. *See Dorris & O'Connell, supra note 10, at 105-106.*

181. *See Adler, supra note 34, at 6.*

182. *See Dorris & O'Connell, supra note 10, at 108-109.*

183. *See id.* at 109.

184. *See id.*

185. *See id.*

186. *See id.*

2. The Perfection of a Security Interest in General and as Related to Copyrights

Due to the ever looming risk that the originator could face bankruptcy, investors must consider the reality that a bankruptcy court could characterize the transfer of the assets from the originator to the SPV as a collateralized loan and not a true sale. Therefore, it is necessary for the SPV to have a perfected security interest in the assets once the assets have been transferred.¹⁸⁷ Real property and other personal property are secured as collateral under the U.C.C. and the perfection of a security interest by a creditor in such property is achieved by a filing with the state. However, recent case law holds that when the underlying asset is a copyright, federal copyright law under § 205 preempts state law and the perfection of a security interest is accomplished by a filing in the Copyright Office of the Library of Congress.¹⁸⁸ The court reasoned that the Copyright Act's recording provisions are comprehensive and the Act itself implicates unique federal interests. Therefore, federal law preempts state methods of perfecting security interests in copyrights and the accounts receivable related to those rights.¹⁸⁹

In the Bowie bonds transaction, the perfection of the security interests in the copyrights were achieved under the U.C.C. and also by a filing with the Copyright Office.¹⁹⁰ However, there was an additional concern which may have had a devastating effect on the bond holders if Bowie died prior to the maturity of the bonds. Some of Bowie's compositions were written before the 1976 Copyright Act was implemented. The compositions written prior to the 1976 Act fall under the guise of the 1909 Copyright Act. Under § 24 of the 1909 Copyright Act, original works of authorship created prior to 1978 may be renewed by an author's heirs.¹⁹¹ Therefore, in the event of Bowie's death, his heirs would have a claim to the copyrights of compositions written

187. See Simms, *supra* note 139, at 373-376.

188. See *In re Peregrine Entertainment Ltd.*, 116 B. R. 194, 16 U.S.P.Q.2d 1017 (C.D. Cal. 1990). See also Bencivenga, *supra* note 38, at 5.

189. See *In re Peregrine Entertainment Ltd.*, 116 B. R. 194, 16 U.S.P.Q.2d 1017 (C.D. Cal. 1990). See also ROBERT A. GORMAN & JANE C. GINSBURG, COPYRIGHT FOR THE NINETIES (4th ed. 1993) at 290.

190. See Bencivenga, *supra* note 38, at 5.

191. 17 U.S.C. § 24 (1976).

under the 1909 Act.¹⁹² To resolve this potential cloud on the title to the copyright(s), the attorneys obtained releases from Bowie's heirs.¹⁹³

In addition to copyright law, the U.C.C. applied to the Bowie bonds transaction.¹⁹⁴ Be forewarned that not all security interests are governed by the U.C.C.¹⁹⁵ The particular asset type should be examined on a case-by-case basis. Article 9 of the U.C.C. applies to the sale of accounts and chattel paper.¹⁹⁶ The U.C.C. in section 9-105 defines "chattel paper" as "[a] writing which evidence[s] both a monetary obligation and a security interest in or lease of goods."¹⁹⁷ The U.C.C. also covers the perfection of security interests in certain transactions, including many types of financial assets that are defined as accounts, chattel paper, general intangibles and instruments.¹⁹⁸ Under U.C.C. section 9-106, a "general intangible" is defined as any personal property other than goods, accounts, chattel paper, documents, instruments and money.¹⁹⁹

In order to perfect a security interest under the U.C.C., the security interest must attach. This may be accomplished under U.C.C. section 9-203 when: (1) the secured party possesses the collateral or the debtor has signed an agreement that describes the collateral; (2) value is given; and (3) the debtor holds rights to the collateral.²⁰⁰ To perfect this security interest, a financial statement must be filed against the debtor in the state that contains the principal place of business of the debtor²⁰¹ or in the state or county where the assets are held.²⁰² However, a security interest in an instrument may only be perfected by the secured party possessing the instrument.²⁰³

192. In the Bowie bonds transaction, the lawyers had Bowie's heirs release their rights to renewal and acknowledged that this release only protected against the renewal rights of those heirs now living and did not take into account any potential heirs if Bowie divorced and remarried or had more children, natural or adopted. See Bencivenga, *supra* note 38, at 5.

193. See Bencivenga, *supra* note 38, at 5.

194. See Adler, *supra* note 34, at 6.

195. See Dorris & O'Connell, *supra* note 10, at 113.

196. See Simms, *supra* note 139, at 373-374.

197. See *id* at 374.

198. Dorris & O'Connell, *supra* note 10, at 113-114. See also Simms, *supra* note 139, at 375.

199. See Simms, *supra* note 139, at 374.

200. See *id* at 375.

201. See *id*.

202. See Dorris & O'Connell, *supra* note 10, at 113.

203. See U.C.C. § 9-304 (1995). This provision of the U.C.C. is subject to certain exemptions. See Simms, *supra* note 139, at 376.

“Security interest” is defined in U.C.C. section 1-207(37).²⁰⁴ This interest includes an ownership interest in accounts and chattel paper. It is necessary for the bond holder to ensure that its interest is superior to any potential creditors of the SPV or originator.²⁰⁵ This is so that creditors cannot interrupt the flow of income to the bond holder by making claims against the assets.²⁰⁶ To ensure priority of interests, the bond holder must possess a first priority lien against the assets.²⁰⁷

In the realm of high technology, intellectual property assets include copyrights, trademarks, patents and trade secrets, and the incomes derived from those assets. As with the Bowie bonds transaction, the security interest in the copyrights would be perfected under the U.C.C. and in the federal copyright office.²⁰⁸ Similarly, patents and trademarks require filings both under the U.C.C. and with the Patent and Trademark Office.²⁰⁹ A filing under both state and federal systems ensures that a SPV’s and subsequent investor’s interests are maintained in the intangible property right from which an income stream flows.

*D. What You Need, You Have to Borrow:
The Issuance of Securities by the Special Purpose Vehicle*

Like the other steps in an asset-backed securities transaction, the issuance of securities consists of a few overlapping steps: the actual issuance; the rating of the securities; and credit enhancement.

1. The Issuance of Securities

The issuance of securities by a SPV/corporation is provided by corporations law in the state where the corporation is formed.²¹⁰ Issuances are permitted in the enumerated powers that are granted by a state’s statutes and which cover the legal powers of a corporation.²¹¹ While the authority to issue equity securities is required by law to be set forth in the corporation’s certificate of incorporation, filed with the state in which the entity is incorporated, the power to issue debt secu-

204. “‘Security Interest’ means an interest in personal property or fixtures which secures payment or performance of an obligation.” U.C.C. § 1-207(37) (1995).

205. See Dorris & O’Connell, *supra* note 10, at 113.

206. See *id.*

207. See *id.*

208. See Bencivenga, *supra* note 38, at 5.

209. See *id.*

210. See RICHARD T. McDERMOTT, *LEGAL ASPECTS OF CORPORATE FINANCE* 94 (1985).

211. See *id.* at 93-94.

rities need not be in the certificate.²¹² The actual bond issuance is a matter of paperwork: opinion letters from attorneys; corporate documents duly filed with the state; the authentication of the debenture; assignment forms.²¹³

Rudder, Bowie's attorney in the deal, indicated that Prudential Investments wanted a number of opinion letters that covered matters standard to any asset-backed securitization.²¹⁴ Rudder opined that the notes were valid, binding, and enforceable, in addition to being duly authorized, executed, and delivered.²¹⁵ Rudder indicated that some of the opinion letters covered matters of more complexity such as bankruptcy issues and the creation of a perfected security interest in the assets that were used to back the bonds.²¹⁶

From the little that is written about the actual issuance of bonds, it appears that this portion of the transaction is the least problematic. Establishing the safety nets to ensure that there are no defaults in payments, ensuring that the SPV stands and operates independent from the originator to avoid consolidation, and building the legal framework in order to obtain benefits under tax laws pose the greatest difficulties for lawyers.

2. Ratings, Ratings, Ratings: You Really Made the Grade

At some point, the securities must be rated so that they may attract investors. Perhaps the most well-known and widely accepted rating agencies are Standard & Poor's Ratings Group, Moody's Investors Services, Duff and Phelps, and Fitch Investors Service, Inc.²¹⁷ Rating agencies typically examine the assets held by the SPV or corporation when rating securities, instead of the credit record of the originator.²¹⁸

Credit ratings are most basically assessments of risk and are not recommendations to enter a securities transaction.²¹⁹ Ratings are essentially measures that determine a security's level of protection

212. *See id.* at 95.

213. *See id.* at 93-95.

214. *See Adler, supra* note 34, at 1.

215. *See id.*

216. *See id.*

217. *See Schwarcz, supra* note 1, at 520 n. 14.

218. *See Jackson, supra* note 86, at 197.

219. *See The Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, supra* note 9, at 535.

against credit loss.²²⁰ Credit ratings are opinions about both the absolute credit risk of a default of payment on the security and the relative credit risk vis-à-vis other categories of ratings.²²¹ If the pro forma payment of royalties to the SPV could be demonstrated by showing the average amount of royalties paid over a certain length of time to the originator, and the amount of royalties is steady, dependable, and could support interest payments on the issuance of bonds, the SPV could be evaluated at a higher rate. An originator may not be able to receive an investment grade rating, and yet the SPV, evaluated independently from the originator, may very well obtain one.²²²

Moody's Investors Services (hereinafter "Moody's") was employed to rate the Bowie bonds.²²³ The bonds achieved a 3A rating.²²⁴ Although this rating is below an AAA rating, it is still an investment-grade rating.²²⁵ Undoubtedly, this rating enabled the bonds to be snatched up very quickly by Prudential Investments. Moody's had to be assured that the assets were of a certain quality and that the SPV was truly independent from the originator.²²⁶ Credit enhancements were designed, including certain guarantees from EMI, to compensate the payments on the bonds if the revenues from the royalties dipped.²²⁷ The bonds holders retained the right to seize Bowie's copyrights if the whole deal fell apart.²²⁸

3. Sweet Thing: The Role of Credit Enhancement

Credit enhancement oftentimes affects the ratings of a security. Credit enhancement may be internal or external and is a tool that ensures that all payment obligations are fulfilled on time so that the risk of default is minimized.²²⁹ In case a dip in the market leads to a decline in royalty payments, underlying sources of credit may be designed to

220. See Richard Cantor & Frank Packer, *The Credit Rating Industry*, FED. RES. BANK OF N.Y. Q. R. 10-12 (Summer - Fall 1994).

221. See *id.*

222. See Schwarcz, *supra* note 1, at 521.

223. See Adler, *supra* note 34, at 1.

224. See Jane Katz, *Getting Secure* (visited Oct. 12, 1998) <http://www.bos.frb.org/economic/nerr/katz97_3htm>.

225. See *id.* See also Adler, *supra* note 3, at 5.

226. See Jane Katz, *Getting Secure* (visited Oct. 12, 1998) <http://www.bos.frb.org/economic/nerr/katz97_3htm>.

227. See Adler, *supra* note 68, at 6.

228. See Bencivenga, *supra* note 38, at 5.

229. See The Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, *supra* note 9, at 534, 549-550.

kick in and thereby prevent the risk of a default of payment on the bonds.²³⁰ With a credit enhancement, a higher rating may be possible and generally, high investment ratings are key to attracting investors.

Typically, there are two categories of credit enhancements. An internal credit enhancement is generated by the corporation or the originator²³¹ and may appear in the form of a cash reserve account. An external credit enhancement, as the name reveals, comes from an outside source, such as a bank.²³² External credit enhancements are more costly because fees are routinely charged for services such as financial guarantees, letters of credit, and default insurance.²³³ If an external credit enhancement source is used, that cost must be calculated into the overall administrative costs which the future receivables must cover.

The credit enhancement has at least two purposes. First, the greater the guarantee of the bond reaching its maturity without a default of payments, the greater the likelihood of attracting a high credit rating.²³⁴ The second and perhaps more important purpose of alternate lines of credit is to protect the originator's assets. A credit enhancement serves as an extra safety net to prevent a default in payment.

As indicated earlier, many of the stages of a securitization occur simultaneously. The process of rating the securities and the acquisition of credit enhancement are areas of the transaction that overlap. This is particularly clear in the Bowie bonds transaction. The securities were rated by Moody's and achieved a 3A, investment grade rating.²³⁵ That rating is due to the fact that tremendous guarantees for the maturity of the deal were provided by EMI, an A-rated, multinational record company. The Bowie bonds received the same rating as EMI because EMI supported the deal.²³⁶

As mentioned above, EMI now possesses both domestic and international rights to the distribution of Bowie's catalog.²³⁷ EMI entered into a fifteen year licensing deal for Bowie's back catalog and this was pledged as collateral to Prudential Investments.²³⁸ After the term of the

230. *See id.* at 549; Adler, *supra* note 3, at 5.

231. *See* The Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, *supra* note 9, at 550.

232. *See id.* at 549.

233. *See id.* at 534.

234. *See id.* at 550.

235. *See* Adler, *supra* note 68, at 6.

236. *See id.*

237. *See id.*

238. *See id.*

licensing contract expires, the ownership of the master tapes reverts back to Bowie.²³⁹ Prudential Investment's Vice President of Structured Finance, Andrea Kutscher, described this underlying collateral as "extra insurance" and explained that EMI is expected to "make good on the payments."²⁴⁰ Kutscher stated that the deal is dependent on the promotional activities of EMI and Bowie's managers, with whom Prudential Investments will work to maximize revenues.²⁴¹

A parallel situation may be found in the high technology arena where a company licenses its patents or other intellectual property to another entity and the licensing agreements are due to expire. In this situation, which is rather simplistic and does not address cross licensing concerns, the licensee may have a strong desire to continue the licensing arrangement such that it is willing to guarantee the asset-backed transaction to the investor for the term of the deal. The desire of the licensee to guarantee the deal rests heavily on the value of the underlying assets to it.

E. Servicing the Assets

After the securities are issued, a servicer may be arranged so that the assets are monitored and collected and the receivables plus interest are paid to the bond holders.²⁴² The servicer may be the originator or may be a third party.²⁴³ Although it is market practice for the originator to service the receivables of the SPV, if the originator retains this task, there are true sale concerns.²⁴⁴ Therefore, it is necessary that the same standards in servicing the assets are adhered to as if the receivables were serviced by a third party.²⁴⁵ A servicer may receive a servicing fee and that fee is taxable.²⁴⁶ Additionally, the SPV should retain the right to revoke the servicer.²⁴⁷

The facts available to the public do not indicate whether or not Bowie, the originator, is servicing the assets. If indeed he is the

239. *See id.*

240. *See Adler, supra* note 68, at 6.

241. *See id.*

242. *See* The Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, *supra* note 9, at 548.

243. *See id.*

244. *See id.* *See also* Simms, *supra* note 139, at 347.

245. *See* Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, *supra* note 9, at 548. *See also* Simms, *supra* note 139, at 347.

246. *See* Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, *supra* note 9, at 548.

247. *See id.*

servicer, it is certain that Rudder opined to Prudential Investments that Bowie's servicing of the assets would not raise consolidation concerns in the event of Bowie's bankruptcy. For an extra guarantee, however, Prudential Investments may have required that Bowie retain a third party servicer due to the fact that the revenues from the royalties of music copyrights prior to this deal were an untested asset class. In the event that a high technology company embarks on a similar deal, utilizing the revenues from an untested asset class, it is likely that the investor would have concerns similar to those highlighted above.

VII. CONCLUSION

Securitization dates from the turn of the century, yet it is only in the past two decades that it has flourished.²⁴⁸ Asset-backed securities are nearly twelve years old and are among the latest financing creations of innovative financiers. Although there are easier ways to finance high technology businesses currently in use such as selling stock, asset-backed securities may be applied as a financing vehicle in the future.²⁴⁹ Asset-backed securities transactions may be a viable form of alternative financing for businesses that have licensed the use of core technologies and have steady streams of income resulting from the licenses,²⁵⁰ provided they have the tenacity to work through the intricacies inherent in such transactions.²⁵¹ The bonds have already been issued in the music industry, which is not as capital-intensive as the film and high technology industries.²⁵² According to one high technology executive, the high technology industry is at a point where companies ought to pursue and evaluate novel financing ideas.²⁵³ Securitization of the intellectual property assets possessed by a high technology company may be just the ticket.

248. See Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1380-81 (1991).

249. See Haber, *supra* note 106, at 1.

250. See *id.* at 93.

251. See Jackson, *supra* note 86, at 210.

252. See Patrick McGeehan, *Rock 'n' Roll Bonds Tap Investors' Faith in Future Royalties*, WALL ST. J., Feb. 10, 1998, at B2 (quoting Lisbeth Barron, a senior managing director at Bear Stearns). Bear Stearns has written asset-backed security transactions for Hollywood film studios and indicated that application of this financing structure is appropriate in a context where there is a need to finance fairly risky films. See *id.* This financing vehicle would also be appropriate for the speculative arena of financing research and development in high technology.

253. See Haber, *supra* note 106, at 1 (paraphrasing Lucent Microelectronics group president Curtis Crawford).