

# Securitization moves up the agenda

Two major US securitization transactions involving sizeable trademark royalty components may finally provide the impetus for the lagging IP securitization market to take off

The closing earlier this year of two major US securitization transactions involving sizeable trademark royalty components may finally provide the impetus for the lagging IP securitization market to take off. The \$1.7 billion Dunkin' Donuts securitization which closed in May (see "Dunkin' Donuts" box) was topped a few days later by a \$1.8 billion deal involving KCD IP. Both deals involved securitization of trademark royalty receivables and related rights and may have provided the necessary comfort to professionals in the field to reconsider the viability of trademark royalties as a suitable asset class for future financings.

## Evolution of IP securitization

Despite the fact that IP royalty streams are capable in many cases of providing a steadier cash flow to service debt than other familiar asset classes (eg, mortgage or lease receivables), the number of IP royalty securitizations that have successfully closed belies the usefulness of IP assets as financial facility collateral. In fact, the evolution of IP assets as a distinct asset class for securitization has recent beginnings – the issuance of 'Bowie bonds' in 1997, in which the royalty payments on David Bowie's back catalogue were securitized. While the celebrity status of the Bowie bonds helped to promote the idea of IP assets as an untapped source of collateral, the market has not flourished to the extent once anticipated.

Of the various IP rights, securitization of copyright royalty receivables far outnumbers the transactions relating to patents and trademarks. Among the most notable copyright receivable securitizations is the 2002 transaction by DreamWorks in which \$1 billion was raised backed by copyright licence receivables on the company's existing film library. Universal Pictures, Village Roadshow and 20th Century Fox have also completed copyright securitization transactions backed by film and television royalties. Among the handful of patent royalty securitizations is the 2000 BioPharma Royalty Trust transaction, which raised in excess of \$200 million backed by patent licence royalties from Yale University's patent over Bristol-Myers Squibb's HIV drug Zerit. In 2003 a

significant patent royalty securitization by Royalty Pharma Finance Trust raised \$225 million on the back of royalties on patents for 13 major patented drugs. The licences were with major pharmaceutical companies such as Novartis, Roche, GSK, Pfizer, Wyeth and Eli Lilly.

Trademark securitization cannot be regarded as common, and in comparison with copyright and patents, securitization for this type of intellectual property has yet to reach its full potential. In addition to the Dunkin' Donuts and KCD IP transactions earlier this year, a small number of other companies have successfully raised capital through securitizing in the past decade. One of the more prominent transactions was the securitization of licence royalties by Guess? Inc that raised \$75 million (see "Guess? Inc" box). BCBG Max Azria has also completed a securitization of all of its intellectual property, including all current and future trademarks. The BCBG Max Azria deal raised \$53 million and was the first major apparel brand securitization that included a retail component. Other significant trademark licensing securitizations were undertaken by Calvin Klein (\$53 million), The Athletes' Foot (\$30 million to \$40 million), Candie's branded footwear (\$20 million), Bill Blass (\$25 million) and Gloria Vanderbilt (\$30 million).

## Basic structure of IP securitization

In most of the IP securitization transactions that have been reported, the basic structure used broadly mirrors those used for typical securitizations of other more common asset classes (eg, pools of mortgage receivables). The relevant asset in an IP securitization is the right to receive royalties from licensees of the IP rights. The right to receive and claim the royalties is transferred from the licensor/IP owner to a bankruptcy-remote special purpose vehicle (SPV) in a manner such that the transfer is seen as a 'true sale' rather than a loan arrangement. The difference is significant. The purpose of a true sale transaction is to ensure that the transferred asset will not form part of the estate of the originator in the event of insolvency or bankruptcy. Structuring the transaction as a true sale also assists with achieving the objective of removing the receivables from the balance sheet of the originator and having them replaced with either a profit or loss from the sale.

The SPV itself may be a corporation, trust or some form of partnership, and in recent times it has become common to use an intermediate SPV so as to ensure that the transferred assets are fully isolated. In order to fund the purchase of the assets, the SPV issues and sells debt securities in the form of bonds secured against the assets transferred by the originator to the SPV. The bonds may be publicly traded on the capital markets, but most frequently the



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Example of DUNKIN' DONUTS logo

bonds are privately placed with institutional and other qualified investors such as banks, insurance companies and retirement funds.

Agreements are also put in place between the originator and the SPV to ensure that the receivables are collected from the licensees and flow through to the SPV. The SPV then pays the bondholders according to the conditions of repayment attaching to the bond. As the SPV (and not the originator) will own the IP receivable assets, the investors' decision to purchase can be made without concern for the originator's financial condition. The risk profile of the licensees, however, will be of concern to the investors. The investors are further guided by the credit rating that has been placed on the deal by credit rating agencies (eg, Moody's and Standard & Poor's). Rating agencies often become involved in the transaction at an early stage and frequently dictate the structure and the terms of the legal opinions so as to assist in the rating exercise.

Generally, as the assets transferred by the originator will carry some elements of credit risk, the securitization will require some element of credit enhancement so as to alleviate the risk for investors. Such credit enhancement can take a number of forms – for instance, in the Guess? securitization back-up managers were retained and over-collateralization was put in place to serve as a cushion for the investors.

#### **Peculiarities of trademark securitizations**

Almost all reported trademark securitizations that have taken place to date have been structured under US law. Due to peculiarities in US bankruptcy law, trademark securitizations are structured with a major difference from most securitizations of patents and copyright: in the case of patents and copyright, it is common for the royalty receivables to be assigned to the SPV *without* the need also to assign the underlying patents and copyright. The same cannot be said in the case of trademark securitization. Ambiguity in the interpretation of provisions of Title 11 of the US Code (the Bankruptcy Code) has meant that the underlying trademarks themselves should be assigned along with the relevant royalty receivables to the SPV. If the trademarks are

#### **Dunkin' Donuts**

One of the largest trademark securitization transactions to date was the DB Master Finance \$1.7 billion financing of intellectual property and leases generated by the fast-food brands owned by Dunkin' Brands Inc, which closed in May 2006. The transaction was pursued to help repay a debt of \$1.5 billion following a leveraged buy-out of the company by a consortium of three private equity firms that completed the previous March.

While the transaction cannot claim to have involved a securitization of solely trademark licence receivables, it was primarily motivated by the strength of the Dunkin' Donuts and Baskin-Robbins brands. The transaction involved the issuance of notes to be repaid primarily from franchise royalty payments by the Dunkin' Donuts, Baskin-Robbins and Togo's Eateries franchisees, rent on facilities leased to franchisees and the licensing to third parties of the Baskin-Robbins intellectual property for the production and sale of ice cream. Hence, trademark receivables contributed to a significant portion of the deal.

The transaction was structured so as to transfer various collateral assets relating to existing and future franchise agreements, IP assets and real estate assets leased to franchisees, held by Duncan Brands Inc (DBI) and Baskin-Robbins International LLC to a wholly owned but bankruptcy-remote DB Master Finance LLC (the master issuer) and other related securitization special purpose entities (SPEs).

The master issuer issued triple-A rated secured notes. The transaction was secured by substantially all of the revenue-generating assets that were transferred to the SPE (including the equity in the SPE subsidiaries).

In order to permit DBI to continue functioning as franchisor and to ensure the debt of the master issuer will be serviced by the royalties and other receivables, a master servicing agreement was put in place with DBI. A back-up manager was also put in place to ensure continuity of the franchise operators and continuation of cash flows in the unlikely bankruptcy of DBI.

**⚠ If the trademarks are not assigned, there is a danger that an originator facing bankruptcy may be entitled to reject any royalty-bearing licences as part of a rehabilitation programme thereby undermining the cash flows to the securitization SPV and the investors ⚠**

not assigned, there is a danger that an originator facing bankruptcy may be entitled to reject any royalty-bearing licences as part of a rehabilitation programme, thereby undermining the cash flows to the securitization SPV and the investors.

The ambiguity in the Bankruptcy Code arises as a result of legislation hastily enacted by US Congress in the wake of the decision in *Lubrizol Enterprises v Richmond Metal Finishers Inc* (756 F2d 1043 (4th Cir 1985)). In that case, the US Court of Appeals for the Fourth Circuit permitted the licensor Richmond Metal Finishers (which had filed for bankruptcy) to reject its non-exclusive patent licence with licensee Lubrizol Enterprises. Section 365 of the Bankruptcy Code permits a trustee or debtor in possession to assume and assign or reject an executory contract, in order to maximize the profitability and value of the debtor's estate. Licences of intellectual property are typically classified as executory contracts as the parties on both sides of the contract have unfulfilled obligations.

The *Lubrizol Case* caused consternation as it was feared that the decision would lead to a chilling effect on licences, particularly as businesses would be reluctant to take a licence of technology out of fear that the licence could be taken away if the licensor filed for bankruptcy. In response, US Congress enacted the Intellectual Property Bankruptcy Act of 1988, which inserted a new Section 365(n) into the Bankruptcy Code. A definition of 'intellectual property' (in Section 35A) was also created, which includes trade secrets, inventions, processes or designs protected under patent law, patent applications, works of authorship protected under the copyright laws and mask works. The new Section 365(n) permits licensees of intellectual property from a licensor facing bankruptcy either to treat the licence as terminated or to retain its rights under the licence. Hence, for patents and copyright, the danger created by the *Lubrizol* decision was removed. Unfortunately, the same could not be said of trademarks, which were not included within the definition of 'intellectual property' in Section 35A.

The lack of explicit protection for trademark licensees in the Bankruptcy Code was explained by the Senate as based on the need

to conduct further studies into trademarks, and that in the meantime congressional action in the trademark area would be postponed in favour of permitting development of equitable treatment of this situation by bankruptcy courts. The resulting ambiguity in the law effectively mandates the assignment of trademarks to the SPV in most trademark securitizations, bringing with it various complications as discussed below.

#### Securitization opinions

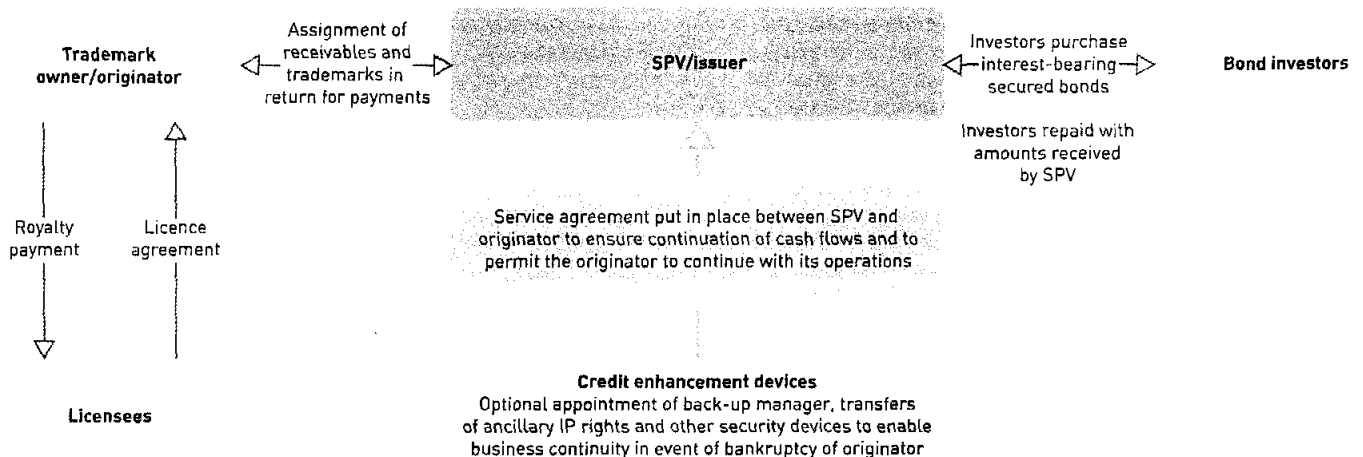
One of the central requirements in structuring a securitization transaction is the presentation of legal opinions, which are drawn up among the legal advisers of the major parties to the transaction. In most cases, the transaction and the related legal opinion should be crafted so as to confer the rating agency with sufficient comfort to rate the transaction. The need for such opinions is couched in the fact that courts have not yet had the opportunity to pronounce on the validity of most securitization structures. Most opinions dedicate a significant proportion of the legal analysis to the propriety and validity of the 'true sale' structure, but in the context of trademarks, much emphasis will be placed on the legal issues (see below) arising from the sale by the originator of the trademark to the SPV in addition to the right to collect the trademark receivables.

One could surmise that legal uncertainty resulting from the apparent need to assign trademarks to the SPV in a trademark securitization may have been a significant contributing factor to the low volume of trademark securitizations. Despite this, industry insiders have been quoted as suggesting that the opinions given to the credit rating agencies as to the structure of the recent Dunkin' Donuts and KCD IP deals may make similar future transactions more attractive.

#### Specific legal issues with trademark securitization

Transferring title in the underlying trademarks to the SPV in US-based securitizations gives rise to a number of legal issues which must be specifically addressed when structuring the deal. These issues will not necessarily arise in some European or other global

### Structure of a trademark securitization



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Example of a GUESS JEANS logo

jurisdictions where an assignment of the royalty receivables on their own is sufficient; however, in light of the US-centric nature of trademark securitizations, some of these issues are introduced here.

**Assignments of goodwill and quality control:** Under US law (and the law of many other countries) a trademark cannot be assigned without its goodwill. Hence, the relevant assignments need to be structured carefully not only to avoid omitting the goodwill but also to ensure that the transaction will survive a judicial examination to determine whether in substance an assignment of the relevant goodwill took place. A trademark assignment which has been found to omit the related goodwill will be deemed void under US law as an assignment in gross.

Once the trademark has been assigned to the SPV, the originator will need to continue its functions and hence a licence back of the trademark rights will be required. This similarly raises issues as to the degree of quality control that needs to be built into the transaction so that the SPV can hold itself out as safeguarding the badge of origin function. In the absence of quality control provisions, there is a real danger that the originator will be deemed to operate under a naked licence which can lead to deemed abandonment of the mark.

#### **Enforcement and maintenance of the trademarks:**

The enforcement and maintenance of trademarks is primarily the obligation of the trademark owner and hence of the trademark securitization SPV. The obligation of the SPV to maintain the relevant marks should be built into the transactional documents. More problematic is the issue of who deals with infringement issues. Trademark infringement may lead to a significant depreciation in the value of a brand which carries a concomitant danger of decreased sales and royalties, all issues which may affect the revenue stream servicing the investors bonds. The SPV, as trademark owner, is the party with standing to take infringement proceedings and hence it is often more appropriate for the originator to take legal action to remedy the infringement. Hence, transactional documents between the SPV and the originator should be structured so as to identify clearly responsibilities for the conduct of litigation and costs, and how recoveries are to be distributed.

#### **Security over trademarks, bankruptcy and foreclosure:**

In order to provide comfort to the investors, the bonds will typically be secured against both the receivables and the underlying trademarks. The security is crafted to ensure that the investors will have recourse to the trademarks in the event the cash flows generated by the IP assets are insufficient or in the event of default. Taking security over the trademarks raises issues as to enforceability, particularly as charges over trademarks in the United States must be perfected in order to be valid. While the legal opinions underlying the transaction will provide some comfort as to the enforceability of these legal charges, most deals will be structured to include credit-enhancement mechanisms that minimize the risk of having to rely on the security. The most typical credit enhancement is the use of a reserve account into which the originator pays sums that can be set off against any shortfall in royalties. A back-up servicer more acquainted with the business of the originator may also be appointed to step into the shoes of the originator in the event of bankruptcy, thereby ensuring continuity of business and hence cash flows (as also happened in the Dunkin' Donuts, KCD IP and Guess? transactions).

In addition to the foregoing, the territoriality of trademarks (and patents and copyright) can add to the general intricacy of IP securitization. Seldom will a trademark securitization relate to licences in place in just one jurisdiction: The Dunkin' Donuts transaction involved royalties generated from franchisees as far afield as Japan under Japanese registered marks. In structuring the transaction it is hence necessary to consider whether local trademark, banking and

#### **Guess? Inc**

Prior to the Dunkin' Donuts securitization earlier this year, this 2003 securitization transaction entered into by Los Angeles based Guess? Inc was regarded as the most high profile and most referenced example of pure trademark securitization.

The transaction involved the use of royalty streams from a pool of 14 different trademark licences as collateral and entailed a transfer of the underlying trademarks and royalty receivables to a specially established special purpose entity, Guess? Royalty Finance LLC. The licences underlying the transaction all had varying durations (from three to 10 years) and granted the respective licensees exclusive non-transferable rights to use certain trademarks on specific apparel and apparel-accessory products. On the basis of royalties which were projected to be in the region of \$23 million and \$22 million a year, the securitization yielded \$75 million for Guess?.

The proceeds of the securitization were used by Guess? to pay off existing (more expensive) debt and the bonds that were issued were rated triple-B by Standard & Poor's. Some of the factors that alleviated the risk for the investors and that were taken into account when rating the transaction included the appointment of a back-up manager who could keep the Guess? business going in the event of the bankruptcy or insolvency of Guess?. The company also had an established reputation and other licensees, which were major factors underlining the originator's ability to service the debt.

company laws facilitate the proposed structure. For example, a restriction on or inability to place a charge on trademarks in a key jurisdiction may be sufficient to undermine the viability of a deal. Accordingly, the due diligence process in securitizations involving IP is often regarded as intensely burdensome and expensive.

#### **The future**

With the increasing prominence of IP assets on corporate balance sheets and the seemingly relentless growth of the IP licensing market (with the concomitant surge in global licensing revenues), many chief financial officers are eager to gain access to the cheaper financing costs that securitization can provide over traditional debt or bank financings. The recent trademark securitizations in the United States have certainly revived the hype in IP securitization, but it remains to be seen whether this area of structured finance will burgeon into the goldmine that was once promised. If nothing else, the recent transactions will provide investors with the confidence to invest in IP-backed securities and hopefully this confidence will also filter out of the United States to other jurisdictions where fewer impediments to the structuring of trademark securitizations exist. WTR

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