

IP Royalty Securitization

Questions & Answers

January 2008

The following is an attempt to answer some of the questions most likely to arise in considering an IP royalty securitization transaction. The following is not intended to be a comprehensive list of all questions, nor are the answers intended to be exhaustive of the subject matter. The standard applied in selecting these questions and answers is to include information most relevant to someone considering an IP royalty securitization. This compilation is not intended to offer legal advice or accounting advice. Anyone desirous of additional information regarding patent royalty securitization should contact any of the personnel listed below at either Brown Rudnick, Commercial Strategy or ipeg Consultancy.

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Q: What does “securitization” mean?

A: “Securitization” is a technique for isolating income-producing assets from bankruptcy risk by transferring them to bankruptcy-remote special-purpose vehicles (“SPVs”), which then issue debt securities payable from the cash flows generated by the assets. These securities achieve ratings which are de-linked from the rating (or lack thereof) of the transferor company or institution. Different series of securities backed by the assets may be issued to respond to investor demand for different maturities (e.g., fast pay/slow pay) and credit qualities (e.g., senior/subordinated). Through internal structuring or third-party credit support, the marketed securities are generally rated between BBB/Baa and AAA/Aaa, although the highest ratings are usually achievable only through wrapping the securities with financial guarantees.

Q: What are the advantages of a securitization over the issuance of bonds?

A: A securitization, unlike a bond, is non-recourse to the sponsoring company. In other words, the company does not guarantee the repayment of a securitization, whereas it generally does guarantee the obligations under a corporate bond issue. In addition, fewer and less onerous financial covenants and operating restrictions may be imposed on the sponsoring company than would be required in a direct bond issuance.

Q: Even if the sponsoring company does not directly guarantee the obligations under a securitization, does it have to guarantee the obligations indirectly by making a general pledge of all of its revenue or assets to secure the obligations?

A: No. Unlike a bond issue, an IP securitization would only be backed by the royalties payable under the IP licenses which are assigned to the SPV. While the sponsoring institution in a securitization may be required to provide certain “performance” guarantees in respect of certain non-financial contractual obligations on the part of a subsidiary or SPV, it is generally not required to provide financial guarantees.

Q: Then how does a securitization get high ratings from the rating agencies?

A: The rating is based solely on an analysis of the reliability and predictability as to timing and amount of the revenue stream produced by the assets which are transferred to the SPV to secure the obligations, and on senior/subordinated structures or financial guarantees from third parties.

Q: Will a securitization of IP royalty revenues be classified as debt of the sponsoring institution for financial accounting purposes or for purposes of determining the rating on the sponsoring institution's bond obligations?

A: This is dependent on the financial reporting standards of the country whose rules apply to the sponsor. It is usually possible in most jurisdictions to structure the transaction so as to achieve the desired accounting treatment for the sponsor.

Q: In order to securitize IP royalty revenues is it necessary to assign or pledge title in the intellectual assets themselves (i.e., patents, trademarks or copyrights) to the investors?

A: A securitization of IP royalty revenues generally does not require that the IP be pledged or assigned, although this is an optional feature, and doing so might achieve more favorable rating results and funding terms. Generally, an IP royalty securitization will, as a baseline requirement, require only that the sponsoring company's royalty revenue rights be unconditionally assigned (without recourse to the sponsor) to the SPV, and the SPV will then issue debt securities which are collateralized by the royalty revenue rights.

Q: Will an IP royalty securitization trigger taxable income on the patent royalty revenues which are securitized?

A: An IP securitization in the U.S. will not result in a taxable sale to the sponsor provided that the transaction is structured to qualify as a debt transaction for U.S. income tax purposes. However, the tax consequences of a securitization transaction will depend on the tax laws of the applicable jurisdiction.

Q: Will it be necessary for the sponsoring company to provide a guarantee in order for the securities issued in a patent royalty securitization to receive a high rating?

A: No. The key benefit of securitization is the ability to achieve a rating on the securities issued without recourse to the sponsoring company and the rating is not directly dependent on the sponsoring company's rating (whether higher or lower).

Q: In order to achieve a high rating on the securities issued in an IP royalty securitization, will it be necessary that the royalties being securitized are from license agreements with highly-rated licensees?

A: While the presence of one or more highly-rated licensees facilitates a rating, it is also possible to attain a favorable rating (and a rating higher than the ratings of the licensees) on the basis of a diverse pool of licenses with licensees having diverse credit profiles and licenses of a diverse pool of intellectual assets.

Q: Is it preferable for an IP royalty securitization to be structured around a single intellectual asset or is it preferable to structure it around diversified assets?

A: IP royalty securitizations have been rated on the basis of either a single IP or a portfolio of IP. There are advantages, however, to a diversified pool of IP from the perspective of the rating agencies' stress cases that will be applied to the cash flows, and from the perspective of investors. Some IP securitizations which were structured around a single patent or a single musical artist have not performed as well as securitizations backed by diversified assets and licenses.

Q: Is it possible to receive a rating on an IP royalty securitization which is higher than the rating on the patent holder-licensor or the lowest rating of the licensees?

A: Yes. The rating agencies have concluded that a patent royalty securitization can be rated higher than the rating of the licensor or the lowest rating of the licensees.

Q: If the sponsoring company has an active business resulting in a dynamic pool of intellectual assets, would it be possible to structure a securitization as a revolving loan structure so that the company can add to its borrowing base as new assets are obtained and begin generating license revenue?

A: Yes. The rating agencies have rated several such revolving structures in recent years. Continuing activities by the sponsor in the same or related space after the initial securitization is considered by rating agencies, credit enhancers and investors to be an enhancing feature of the securitized cash flows, and such deals have been successfully marketed to investors.

Q: If the revenues on the intellectual assets being securitized are dependent upon the business operations of the sponsoring company, does this prevent the securitization from achieving a rating which is materially higher than the rating on the operating company's issued debt?

A: Not necessarily. Both in the UK and U.S. markets, structures have been developed which have made it possible for the rating agencies to assign ratings to the securitized debt which are effectively de-linked from the ratings on the sponsoring company. These structures, often referred to as "whole business" securitizations, have received ratings several notches higher than the ratings of the operating companies on the basis of an analysis of the competitive strength of the operating business, the robustness of the cash flows, and legal structures which isolate the intellectual assets from the sponsor company's bankruptcy risk.

Q: Is there a minimum size for a patent royalty securitization?

A: Because of certain fixed costs, the securitization transaction achieves greater financial efficiency with size. Although there could be exceptions, it is likely that a transaction smaller than 25 million USD in initial principal amount would be uneconomical.

Q: Is there a maximum size for a patent royalty securitization?

A: There is no real size limit. The market for securitized debt is extremely deep, with annual global new issuance volume exceeding \$1 trillion.

Q: If my company were to become a sponsor of a securitization of its IP royalty rights, would it be subjecting itself to the risks and uncertainties of a new form of financing?

A: No. A significant number of securitization transactions involving intellectual property have been publicly rated and closed successfully. Many others have been privately closed with unpublished ratings. They include securitizations of music and film royalties, securitizations of trademark royalties and securitizations of patent royalties.

Q: What is the effect of an IP royalty securitization transaction on the operations of the sponsoring company?

A: The sponsoring company may, as stated previously, retain legal ownership of the intellectual assets from which the license revenue is derived and may also retain control over future licensing activities with respect to the IP, consistent with the terms of the securitization documents. The sponsoring institution may also retain control, in the capacity of servicer, over cash management, reporting, enforcement of license or distribution agreements, amendment or modification of license or distribution agreements, waiver of performance of obligations under the license or distribution agreements, and the disposition of underperforming assets. Additionally, the sponsoring company will have the right to receive all licensing revenue with respect to the royalty rights securitized after satisfaction of all obligations with respect to the securitization during each payment period. However, the sponsor will be subject to strict servicing standards designed to assure a minimum level of quality in the performance of the servicing function, and will be subject to removal for failure to perform to these standards.

Q: What is the timeline for completing a patent royalty securitization transaction?

A: It depends upon a number of factors, including the assets involved in the transaction, the degree and complexity of negotiation of deal points, and issues identified during the due diligence process. Depending upon these factors, a deal may take anywhere between three and nine months from beginning to end.

Q: What is the impact, if any, of the subprime mortgage crisis on the viability of IP securitizations?

A: The subprime mortgage crisis has clearly resulted in a loss of liquidity in the debt markets generally, and this has affected securitizations of all asset types. As a market segment which has contributed over 1 trillion USD of liquidity to the world capital markets, securitization is more than simply a technique for issuing debt securities: it is instead a necessary source of financial liquidity around the globe. Some of the necessary responses to the subprime meltdown will be (a) an adjustment of transaction structures to make sure that they are more transparent and are supported by assets which are properly analyzed and understood; (b) an adjustment to rating agencies' methodology in rating structured debt to take into account the degree of internal correlation among the assets in the securitized portfolio, and to adjust accordingly for stress cases; and (c) a restoration of capital to the financial guarantee firms which have traditionally wrapped structured debt to make sure that they are adequately recapitalized as a result of the losses suffered from their exposure to the subprime market. Securitization of intellectual assets, being relatively new to the securitization market, has always involved in-depth due diligence with respect to the assets in the securitized pool, and prudent legal structures with redundant safeguards against credit and event risk. Because IP securitizations must of necessity be built upon in-depth examination of the intellectual assets, they are arguably among the safer types of securitizations being issued. For all of these reasons, it is possible that the securitization of intellectual assets will be restored to favor in the investment and rating agency community sooner than the more commoditized consumer assets such as subprime mortgages, home equity loans, credit card receivables, and car loans.

Q: What, if any, liquidity is available to finance royalty-producing IP pending the market's recovery from the subprime crisis?

A: Pending the current liquidity crisis, work is continuing on IP-based and other types of securitizations, because of the lead time required to get these transactions to market, and in anticipation of the return of liquidity to the market in the second or third quarter of 2008. Also, there are large numbers of financial institutions and hedge funds which remain liquid and are interested in funding structured debt transactions on a private basis. Many transactions were funded in this manner prior to the meltdown, and it is expected that private sector volume will pick up in response to the stalled issuances in the public market.