

20 Intellectual Property as Securitized Assets

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The possibility of implementing the securitization of IPRs is extremely restricted due to various difficulties involved in such securitization. Looking at the overseas cases of IP-related securitization, the real picture was securitization of "royalty claims." The few cases of IP-related securitization in Japan are also likely to have been conducted by taking the royalty claims as reserves in actuality, though they took a form of transferring IPRs to SPVs. In this respect, the use of limited partnerships would also be appropriate as schemes for IPR-based investment in venture companies. The fact that acquisition of beneficial interest in trusts became permissible for limited partnerships with the recent amendment of law has also helped to expand the scope of limited partnerships' investment in IPRs. However, in order to make this scheme fully functional, early law improvement is desirable so that use of IPRs for trusts in the course of trade would become permissible.

Securitization^(*1) means "a company, etc. transfers specified assets that it owns to a vehicle that is newly established for the purpose of holding assets (called "special purpose vehicle; SPV") and raising funds backed up by cash flows arising from transferred assets through the SPV." It is a revolutionary financial means of raising funds by taking only specific assets as reserves instead of the entire asset base of the fund-raiser.

This securitization method, which was developed in the United States in recent years, has grown considerably in terms of popularity, and the type of assets securitized has also diversified. Such a trend has also been observed in Japan. With a dramatic increase in securitization, the type of securitized assets has also shown great diversification, and the possibility of securitizing "intellectual property (IP)" has come to be seen as advantageous in various quarters.

In light of this situation, this report looks into "IP as assets subject to securitization".

1 Mechanism of Securitization

For successful securitization, assets are required to be transferred to the SPV (true sale) in order to isolate the transferred assets from the originator's credit risk (bankruptcy remoteness).

A special purpose vehicle (SPV) is an independent legal entity that is established for the purpose of securitization, generally in the form of a special purpose company (SPC), trust, partnership, limited liability company, or stock corporation.

In a typical case of securitization, a SPV issues corporate bonds backed up by the transferred assets, pay proceeds from bond issuance to the

originator as consideration for the asset transfer while paying all principals and interests to bond investors from cash flows arising from the assets.

In reality, securitization schemes are often implemented by non-resource loans, a method for offering loan by taking only the SPV's own assets as backing without issuing corporate bonds or other securities (limiting the scope of liable property that serves as reserves for debts to specified assets and substitutes equivalent to the value thereof).

2 Expansion of the Size of Securitization and the Scope of Assets Securitized

Securitization has become considerably popular in the United States where it was developed; in 2001, the amount of asset-backed securities issued in the United States was 2.9 trillion dollars (265 trillion yen), far beyond the amount of straight corporate bonds issued (880 billion dollars). Assets available for securitization have also been diversified to include lease credit claims and mortgages, and securitization of intellectual property (IP) also plays a part in such expansion of the scope of assets securitized.

Even in the United States, however, IP was not securitized in the past due to the uncertainty in cash flow forecasts although it was sometimes used by venture companies as security for financing. Under such circumstances, in January 1997, David Bowie, a U.K. rock star, issued bonds backed by the royalty claims for his music works, and raised 55 million dollars in the U.S. financial markets. This case is recognized as the first IP securitization.

The full opening of the age of securitization in Japan was the establishment of a framework for

(*1) Securitization is often translated as "証券化" or "証券化・流動化" in Japanese. However, in the case of securitization in a broad sense, schemes are often implemented by non-resource loans, a method for offering loans only taking the SPV's own assets as reserves without issuing corporate bonds or other securities. In light of this, in the Japanese version of this report, securitization is translated as "資産流動化" or "流動化."

securitization of lease credit claims upon the enactment of the Law Concerning Regulations of Business for Special Credits (the "Special Credit Law") in 1993. As the scope of assets available for securitization gradually expands (it should be particularly noted that limitation on the scope of assets available for securitization was lifted upon the revision of the Securitization Law in 2000), the amount of asset-backed securities issued increased considerably. In fact, a variety of assets have actually been securitized in recent years, such as railway cars, automobiles, vessels, computers, and medical equipment as movable property, and office buildings and hotels as immovable property.

The amount of asset-backed securities issued in Japan in FY2002 reached about 4.6 trillion yen, growing far beyond the amount of capital stock issued.

The trend of IP securitization in Japan began with the securitization of the ground-based broadcasting right (a type of copyright) in 2002, and the first attempt of securitization of a patent right was made in 2003.

In the earlier case, Shochiku Co., Ltd., a film company, granted TV Tokyo Corp. the ground-based broadcasting right for 34 films that had yet to be aired from among a total of 48 of the popular serial films "It's Tough Being a Man." The SPC, having obtained this content copyright from Shochiku, raised funds from the Industrial Bank of Japan, by offering the royalties for the ground-based broadcasting right from TV Tokyo as backing.

In the latter case, Scalar Co., a venture company holding multiple patents relating to optical technology and engaged in the development of optical lenses, had granted an exclusive license for four patent rights that it owned to Pin Change, Co., Ltd., a venture company within Matsushita Electric Group. Scalar transferred these patent rights to the SPC and then SPC issued corporate bonds and raised funds backed up by the royalties for the patent rights.

3 Points to Be Noted and Problems Concerning "IPR" Securitization

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

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

parties' rights.

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

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

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

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

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

4 Costs and Benefits of Securitization

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

The asset to be securitized must have a reasonable size. As a considerable amount of costs are usually needed to build a securitization scheme, the amount of fees to be paid to a law firm or

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

The Scalar case, the first case of securitization of patent rights in Japan, should be highly regarded as a securitization scheme that was successfully composed, but it should be noted that this securitization was an "experimental" case carried out by members of the ministerial workshop. The amount of funds actually raised through securitization was only about 200 million yen, and for such an amount, it would normally be difficult to acquire benefits that are sufficient to cover the costs to be paid to professionals in law, accounting, tax, and financial affairs, which are considered necessary for setting up such complicated schemes.^{(*)2} Though adopting a form of securitization by transferring the patent rights to the SPV, the scheme, when viewed as a whole, seems to have raised funds by offering royalties to be paid by Pin Change as substantive reserves.

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

5 Overseas Securitization of IP

Pure IPR securitization is also rarely seen abroad and most cases seem to involve securitization of royalty claims. In most of these cases, the assets securitized are the royalty claims for music copyrights. While they are generally royalty claims for music copyrights of individual artists, some are royalty claims for music copyrights owned by music publishers (TVT Records, Corinthian Group). In addition, securitization by SESAC is unique in that the securitized assets are the royalty claims for music copyrights owned by a copyright management

organization.

Furthermore, there are some cases in which the royalty claims for film copyrights and the royalty claims for design rights or trademark rights have been securitized.

The detailed schemes for most of these securitization cases are unknown since accessible records are extremely limited, but funds often seem to be raised by issuing privately-offered corporate bonds. Even though the bonds are privately-offered in form, some of them are practically loans, such as those that are underwritten by a single institutional investor like a life insurance company. Also, securitization by a non-recourse loan in which IP or IPR is transferred to the SPV, whereby a loan is provided taking only that asset as a reserve, seems to be one of the basic patterns used.

The securitization schemes can be categorized as follows:

- (i) issuance of publicly-offered corporate bonds (typical securitization);
- (ii) issuance of privately-offered corporate bonds;
- (iii) privately-offered bonds that are practically IP-backed loans (e.g., privately-offered bonds underwritten by a single institutional investor); and
- (iv) non-recourse loans collateralized by IP (IPR).

In addition to these, (v) a scheme of securitizing rights in small portions could also be added. However, since this scheme does not sufficiently secure bankruptcy remoteness of the assets at all and the investors would directly bear any risk concerning the assets, it would be better to distinguish this scheme from securitization.^{(*)3}

As far as the author can confirm, the cases of IP-related securitization overseas are all categorized under schemes (ii) to (iv) above.^{(*)4}

6 Finance for Venture Companies and Asset Securitization

If IP can be securitized, the company that implements securitization (originator) can distinguish the evaluation of the IP from the evaluation of the company and raise funds based on the IP's credibility and cash flows. For this reason, IP securitization is expected to bring about particularly large benefits to venture companies.

Generally, venture companies do not have a lot of tangible assets such as land, buildings, and machinery/equipment, and it is quite often the case that most of their assets are IP. In many cases, they

(*)2 Unlike a home appliance product or similar that requires a large number of mutually related patents for a single product, the number of patents used in a single product was relatively small and that played a decisive role in commercialization of the product in the Scalar case of patent securitization. This is considered to be one of the important factors that enabled patent securitization in this case.

(*)3 The Tokimeki Memorial case, which is often cited as an example of IP-related securitization in Japan, is not a case of asset securitization but a case involving investment trust.

(*)4 Apart from these, there are only a few cases using the "whole business securitization" scheme, and they are mainly in the United Kingdom.

have difficulty in raising funds for their business because they have yet to fully develop or acquire sufficient creditworthiness, even though they have advanced technology or original know-how. Under such circumstances, there is strong demand for a mechanism in which such venture companies will be able to raise funds based on their IP that is independent from the evaluation of the company, and in this respect, IP securitization is recognized as an effective method.

However, in the case of a venture company, its cash flows cannot be counted on and its liquidation value is also low. Furthermore, high risk due to extremely high uncertainty of its business will inevitably result in high interest rates. Consequently, considering venture companies' high demand for funds (to be largely invested in R&D projects) and high uncertainty, equity financing without a definite repayment deadline seems to be more suitable for them than debt financing with a definite deadline.

However, financing through equity investments by venture capitals is often inappropriate for venture companies that are not expected to go public or most small and medium-sized enterprises (SMEs) in which the owner-manager wants to maintain the management right.

In this respect, there is a scheme to invest in private equity called the "private equity fund." However, the private equity fund is mainly used for buying and reviving a failed company or business or one in financial difficulty, and gaining a return by selling it, so it is actually closer to "business revival" or "business management," and would exceed the scope of an "investment" scheme.

Nevertheless, if an investment scheme is to be set up while carrying out the various management and maintenance tasks, and responses to infringement related to IPR securitization that have been discussed so far, it would be closer to "business management," so a scheme using the private business fund would be more appropriate. Indeed, IP investment schemes having the nature of private equity funds have already begun to be set up in Japan.

On the other hand, one possible method to meet venture companies' financing needs while enabling investors to make profits would be receiving returns not only from public sales of shares of the invested companies but also from cash flows that will be generated from the business itself.

Accordingly, attention will be drawn to corporate finance through investments aiming for profits arising from the business, rather than through debt or equity financing. The use of limited partnerships would be appropriate as investment schemes.

A limited partnership for investment, a

partnership under the Law on Limited Partnership for Investments enacted in 1998, can be established in accordance with the legal provision that limited partners, who do not engage in operating the partnership, shall only be liable within the limit of the amount of their contributions. This partnership system is intended to encourage various types of investors to supply funds for venture companies. Within the scope of its operation, a limited partnership is allowed to obtain and own venture companies' IPRs. If a limited partnership is also allowed to use the trust system for IPRs, the usability of such a partnership in investment activities will increase significantly. The investment scheme through IPR trust is expected to become available upon the revision of the Trust Law, which will be deliberated in the ordinary session of the Diet in 2004. If it becomes possible to operate an IPR trust as a commercial trust, IPRs will be more effectively used as assets under the scheme through a limited partnership.

7 Conclusion

As a result of the study in this report, it was confirmed that various difficulties are involved in securitization of IPRs. Underlying these difficulties is the essential nature of the rights themselves, such as the individuality of the respective IPRs and the exclusive rights to use without ownership.

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

Looking at the overseas cases of IP-related securitization, the real picture was securitization of royalty claims. The few cases of IP-related securitization in Japan are also likely to have been conducted by taking the royalty claims as reserves in actuality, though they took the form of transferring IPRs to SPVs.

In this manner, asset securitization is not suitable for raising funds by use of IPRs. On the other hand, royalty claims could be used in cases of securitization in the future to a certain extent, although there are various points to be noted and problems compared with general money claims, since they derive from IPRs.

Recently while IPR-based investment in venture companies is drawing public attention and is being considered as a national economic issue, the use of limited partnerships would also be appropriate as investment schemes. The fact that acquisition of beneficial interest in trusts became

permissible for limited partnerships with the recent amendment of the law, has also helped to expand the scope of limited partnerships' investment in IPRs. However, in order to make this scheme fully functional, early law improvement is desirable so that use of IPRs for trusts in the course of trade would become permissible. Nevertheless, even under the current law, it would be possible to use a scheme in which a limited-liability intermediate corporation^(*5) acts as the trustee.

The examination in this report only provides the initial groundwork for the study of IP and IPR as assets, and needs more detailed consideration, particularly with regard to the individual issues. Furthermore, when actually building an investment scheme based on the views in this report, a more detailed review would be required from practical and theoretical viewpoints. The author would like to expand the research base on the issues and topics covered in this report by gaining advice from various quarters.



(*5) It is completely different from a "limited partnership for investment."

