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How Royalty-Backed Securitization Could Top the Charts of Music Industry Finance

Most musicians and recording artists spend their careers trying to create the next big hit, but successfully securitizing the current and future fruits of their labor could result in the kind of investment that resonates with fans and financiers alike. Some have dubbed such deals "royalty-backed securitizations." Simply put, artists and other holders of royalty rights can fund new projects with the future royalty payments they expect to generate from their existing work.

The concept of royalty-backed securitization hit the financial scene several years ago. It shares the basic building blocks of securitizations involving credit cards, automobile loans and equipment leasing, but instead involves an esoteric asset. To clarify, all asset backed securities are investment vehicles based on revenue streams flowing from pools of assets. What distinguishes royalties from other asset classes is that, instead of being based on hard assets like a car or a piece of equipment that can be easily foreclosed upon if a deal goes bad, royalties are based on an esoteric asset pool comprised of intellectual property rights—music royalties.

Parties in a royalty-backed securitization can benefit from the same diversity of funding sources, liquidity and credit ratings that make most asset backed securitizations an attractive way to fund both current operations and new ventures. Moreover, at least some wealthy music fans may be eager to invest in their favorite song or artist. The purpose of this article is to provide a general overview of how royalty-backed securitizations work and to encourage further use of royalty-backed securities by leaders in the music, business and financial industries.

What is Royalty-Backed Securitization?

Royalty-backed securitization belongs to a broad category of "whole company" securitizations in which the securitized assets must be managed to continue generating revenue. That means the artist, music publisher or record company in a royalty backed securitization retains a certain amount of control over the assets and the life cycle of the transaction proceeds as the artist earns royalty payments. The asset pool could include bundles of rights in publishing royalties, sales of albums and merchandise. To hedge against a downgrade in the popularity of a new hit song or artist, all of the assets in the pool should be based on well-established pieces of work that are of good quality and that generate a steady, predictable stream of royalty income. Parties negotiate "eligibility criteria" that will generally dictate threshold levels of asset quality to be included in the applicable asset pool.

In one early example, English rocker David Bowie was paid $55 million up front via the sale of "Bowie Bonds," which were securities backed by future royalty streams from his pre-1990 body of work. Bowie forfeited his royalty rights for a 10-year period so the future royalty payments could serve as collateral for the bonds; in 1997, an insurance company bought the entire issuance. Bowie Bonds remained in the institutional market until their 10-year term expired. At that time, Bowie resumed sole ownership of his music and royalties.

The Bowie Bond transaction was backed mostly by the copyrights to some of Bowie's most iconic songs, but several kinds of music royalties exist that may be ripe for securitization. The following table summarizes some of their basic characteristics:

	Artist Royalties	Publishing Royalties	Mechanical Royalties	Performance Royalties	Synchronization Royalties
Basis of Right to Royalties	Exclusive to recording artists	Copyright owners of a musical composition	Exclusive to publishers	Membership in performance rights organizations such as ASCAP, BMI or SESAC	Membership in performance rights organizations such as ASCAP, BMI or SESAC
Source of Royalty Income	Percentage of album sales based on negotiated agreements between artists and record companies	Proceeds from the licensing, performance or sale of copyrighted material	Record companies paying to use original or cover songs on other records	Payments from broadcast or public performances that are distributed to members based on set formulas	Percentage of film or video sales based on negotiated agreements between copyright owners and licensees

What are the Benefits of Royalty-Backed Securitization?

Securitization allows originators to obtain future income today. In a royalty-backed securitization, originators can secure cheaper financing than may be available through a traditional bank loan, and investors can yield a higher return than may be achievable through investing in comparable corporate bonds. Often this occurs because the securitized assets are better or more attractive to creditors than the originator of those assets. And, compared with most traditional asset classes, royalty-generating assets are significantly more likely to appreciate over time.

Artists or companies will again receive their regular royalty payments as soon as sufficient payments have been collected to pay off the investors. Allocating royalty payments this way allows originators of the underlying assets to recoup any excess royalties generated by their intellectual property and allows artists to retain at least some creative control over their work. There may be several tax advantages as well, depending on the structure of the transaction and the jurisdiction in which the parties and securitized assets are located.

What Happens in a Royalty-Backed Securitization?

The securitization of current and future royalty income first requires that an originating artist, a collection of artists or a music publisher transfer a bundle of rights in royalty-generating assets to a bankruptcy-remote special purpose vehicle (an "SPV"), which is typically a limited liability company created by the originator for the single purpose of holding all of the assets belonging to that particular deal. Transferring assets to an SPV improves the credit profile of the transaction because royalty-generating assets often appear more attractive and predictable to investors than the actual originator; for example, Moody's gave Bowie Bonds an AAA rating.

Credit enhancements of this sort stem primarily from the ability of an SPV to insulate investors from the risk of bankruptcy by the originator. For that reason, legal counsel must be consulted well before the transfer occurs to ensure the transfer effectuates a "true sale" of the royalty-generating assets. A true sale must be conducted at arm's length—requiring the SPV to pay the originator a fair price for the assets. Thus, to finance the purchase of the deal assets from the originator, the SPV sells debt interests (e.g., Bowie Bonds) in its newly acquired royalty rights.

This process can be complicated because both the transfer and securitization of these rights requires due diligence with respect to copyright, patent, bankruptcy, tax and securities laws as well as the Uniform Commercial Code. In any securitization involving intellectual property, close attention must be paid to who actually owns the licensed material and when those rights expire. Valuing music royalties also may be difficult, particularly in light of illegal peer-to-peer music file-sharing platforms. Still, the success in recent years of for-purchase music sites such as iTunes has somewhat mitigated those concerns. A structured cash flow analysis must be conducted at the outset of the transaction to determine how any gains or losses will be allocated among the parties and to ensure the resulting cash flow waterfall will not divert royalty payments away from investors in the event an originator or other transferor files a bankruptcy petition.

As a practical matter, much of the securitization process takes place simultaneously on the closing date. The SPV holds the royalty rights as collateral for the securities until they generate enough income to pay back the principal and interest owed to investors. Before the securities are sold to investors through either a public offering or private placement, however, originators usually appoint an independent servicer or trustee to administer the flow of royalty payments. This extra step not only further insulates the parties from potential consolidation in bankruptcy but also assures investors that the royalty payments will be properly managed. From there, the parties can proceed pursuant to the terms of their various agreements.

What are the Key Legal Issues in a Royalty-Backed Securitization?

Parties seeking the financial and economic benefits of royalty-backed securitization should consult legal counsel at all stages of the deal, but specifically with respect to the relevant laws governing each of the following issues:

- Securitizing Intellectual Property—a significant amount of diligence must be completed regarding the creation, perfection and enforcement of interests in the underlying assets.
- Selecting and Valuing Royalty Assets—multiple factors guide the determination of royalty rates and other valuations of licensed intellectual property.
- Creating the SPV—the SPV must be a bankruptcy-remote entity that is structurally conducive to meet the needs of both the originator and investors.
- Conducting a True Sale—a true sale opinion should state that, upon the filing of a bankruptcy petition by an originator or other transferor, a court would likely find that
    - the transfer of assets from the originator to the SPV, and any subsequent transfer of assets from the SPV to an independent servicer, was a true sale; and
    - investors' ability to collect on the royalty rights should not be stayed under section 362(a) of the Bankruptcy Code.
- Non-consolidation Analysis—a non consolidation opinion should state that in a bankruptcy filing, the assets are not part of the originator's estate under Section 541 of the Bankruptcy Code.
- SPV Liability—consideration must be given toward whether, and to what extent, an independent servicer or trustee should be used to manage the flow of royalty payments.
- Complying with Securities Laws—requirements vary depending on whether royalty-backed securities are being sold in a public offering or a private placement.
- Ensuring proper Tax and Accounting Treatment for all Parties

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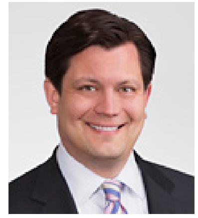
The legal complexity of royalty-backed securitization may prevent some artists or other holders of royalty rights from pursuing securitization as a viable way to fund new ventures. But the increase in recent years of structured transactions backed by intellectual property and the prevalence of royalty-based holding companies in the music industry may indicate that royalty rights are maturing into a distinct asset class. And, given the ability of a royalty-backed securitization to provide money up front for artists' future earnings, it's no wonder the concept has struck a chord with several famous musicians. Since the success of Bowie Bonds, for example, notable artists such as James Brown, the Isley Brothers, Iron Maiden and Rod Stewart have all engaged in some form of royalty-backed securitization.

Ultimately, as royalty-backed securities evolve from a marginal to mainstream investment vehicle, more lucrative deals may lie with the holders of royalty rights to multiple artists' work. Originators and financiers looking to do more than merely reprise previous deals should also explore cutting-edge ways to get fans invested; new technology and web-based music platforms may allow everyone to end on a high note. Certainly, legal challenges persist with respect to the valuation and perfection of future royalty interests. But perhaps the stage has finally been set for royalty-backed securitization to be the next big hit in music industry finance.

How Can We Help

We have an industry leading asset securitization and structured finance practice focused on helping clients finance a broad range of financial assets. Our attorneys have a deep understanding of the nuances and complexities of executing highly sophisticated financing transactions in a rapidly changing marketplace. We are dedicated to bringing creative, practical and efficient solutions to our clients' asset based financing needs in the U.S. and abroad. If you would like to discuss how royalty-backed securitizations could be helpful to your business, please contact any of the following attorneys, your primary Chapman attorney or visit us online at chapman.com.



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