

# Financial Services

Providing Strategic Legal Guidance to the Global Financial Services Industry

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## Recent Developments in the Market for Royalty Securitizations

The robust market for royalty securitizations from 2018 has continued apace through Q2 2019 and is on track to show significant gains in 2019. New issue volume in whole business securitizations consisting primarily of royalty securitizations has been reported as totaling \$6.725 billion in 2018 and is already at \$5.785 billion in 2019 through Q2 (compared to \$2.825 billion in 2018 through Q2 2018).<sup>1</sup> The strong market for other esoteric royalty securitizations from 2018 also continued through Q2 2019, including securitizations backed by intellectual property royalties, media royalties and other types of royalties.<sup>2</sup>

### WHOLE BUSINESS SECURITIZATIONS

Whole business securitizations of businesses that rely on a franchise model to generate royalties, some of which include both U.S. and non-U.S. operations, saw a significant number of both repeat issuances (including refinancing transactions) and first-time issuances in 2018 and 2019 through Q2 2019.

The market for whole business securitizations continues to be dominated by the securitization of nationally- and internationally-recognized restaurant businesses in which franchise assets, intellectual property rights and other assets related to the restaurant business are transferred to one or more newly-formed, bankruptcy-remote special purpose entities which then issue notes backed by the revenue stream(s) generated by such assets. These revenue streams typically consist primarily of franchise royalties generated pursuant to franchise agreements. In some cases, the restaurant business also owns branded locations, and the securitization can get the benefit of these assets whether the real property and other assets relating to these company-owned locations remain “above-the-line” (*i.e.*, outside the securitization) with one or more non-securitization entities, or are assigned “below-the-line” (*i.e.*, into the securitization). In the event these assets stay outside of the securitization, the non-securitization entities typically pay “synthetic” intercompany royalties to the securitization entities in return for the right to use the intellectual property relating to the restaurant business.



In the event the real property and other assets relating to the company-owned locations are assigned into the securitization, the monthly profits on such company-owned locations are included as part of the revenue stream generated by the assets held by the securitization entities. Rating agencies continue to vary on how they view the revenue stream generated by these company-owned locations in rating the underlying securitization. The revenue stream generated by the franchise royalties and synthetic royalties or monthly profit on company-owned locations may be supplemented by other revenue streams generated by the restaurant assets, including revenues generated by branded products and service licenses granted to third parties.

The flexibility achieved in applying the whole business securitization model to other types of businesses to achieve attractive pricing on their financing, while also permitting efficient execution and lower cost for repeat issuances to quickly take advantage of optimal market conditions for financing and refinancing, has resulted in the expansion of the whole business securitization model into additional business sectors over time. Of particular note, the market for whole business securitizations has continued to expand beyond the securitization of restaurant businesses, including first time issuances in the following industries in recent years: (i) the largest nationwide franchise of spa and massage therapy service locations, (ii) a nationally franchised network of accredited early childhood/pre-kindergarten education and day care centers in the United States, (iii) a franchised network of automotive repair operations, (iv) the largest coin exchange business in the United States operated through branded kiosks and (v) one of the largest franchisors and operators of fitness centers in the United States by number of members and locations. As a result, the cash management system (an integral component of any whole business securitization) and other aspects of the whole business securitization model have been modified to reflect the operations of these different businesses and to address business and legal concerns that are specific to their assets and operations. New innovations have also included the use of whole business securitization to finance acquisitions, including permitted brand acquisition and disposition mechanics in existing deals, as well as “pre-funding” accounts allowing the financing of “tuck-in” acquisitions post-closing of a financing.

### **MEDIA ROYALTY SECURITIZATIONS**

Media royalty securitizations have expanded beyond the “Bowie bonds” recognized as the first music royalty securitization in 1997 to permit recording artists and other copyright owners and licensees of music catalogs to receive an upfront payment on future royalties generated by sales, publishing and/or performances of music catalogs. These securitizations have been structured in a variety of ways that are as complex as those applied in whole business securitizations. The future royalties to be generated by such intellectual property catalogs can be made more predictable and resilient by including content with a longer revenue history or a catalog with a wider range of content. The due diligence required in an intellectual property royalty securitization—where all of the revenue generated is dependent on rights to copyrights to be transferred to the securitization vehicle—can be time consuming, in particular when the right to the copyrights has been assigned multiple times. Such structures typically benefit from extensive overcollateralization in order to ensure payments on the notes under various stress scenarios that can include a potential downturn in business conditions to the underlying licensees and other third parties that generate the royalty stream. Credit enhancement is also provided through interest reserve accounts and other reserve included accounts as part of the structure in similar manner to other whole business and esoteric securitizations.

A recently-closed music royalty securitization provided for the notes issued pursuant to the securitization to be backed primarily by the revenues generated by music performance royalty fees. These fees are generated through the aggregation of music performance rights of a catalog of music—the rights to publicly “perform” recorded works by the applicable artists in public spaces, such as bars, restaurants, bars, television networks and music streaming services—and the licensing of these rights in return for a music performance royalty fee. These fees are then be aggregated in the securitization entity to back the notes issued pursuant to the music royalty securitization.



Similarly, while film royalty securitizations were initially introduced by film companies to help cover the cost of production of films through receipt of an upfront payment on the projected future film receipts and distribution rights on films in production, film royalty securitizations were subsequently expanded to securitize the royalty stream generated by one or more films in various stages of development and production or that had already been developed and produced awaiting release in theatres and other venues. These securitizations have been structured with varied forms over time, including one of the largest film securitizations which was backed by the royalties generated by the entire film library owned by the sponsor of the securitization to finance the development and production of additional films over time. The sources of revenue included in royalty securitizations are expected to reflect the development of the film business over time, including licensing of television rights, streaming rights and other digital rights, distribution of media and revenues generated by other more recent distribution channels.

### DRUG ROYALTY SECURITIZATIONS

In drug royalty securitizations, a sponsor, either directly or indirectly through private equity funds and other investment vehicles, purchases the right to a royalty stream granted to a royalty recipient (typically an inventor, academic institution, research institution, biotechnology company or pharmaceutical company holding intellectual property rights in drug products invented by them) as the licensor under a license agreement entered into with a pharmaceutical company or other entity that will develop, market and commercialize a drug product. The royalty recipient typically retains the intellectual property rights to the drug product it licenses to the pharmaceutical company or other entity that develops, markets and commercializes the drug product. The retention by the royalty recipient of these intellectual property rights requires additional due diligence as to the status of such intellectual property rights and additional risks associated with the royalty recipient's maintenance of such intellectual property rights. A sponsor will accumulate a targeted portfolio of such drug product royalty rights for transfer to a securitization entity that will issue notes backed by such revenue stream.

In another drug royalty securitization structure, a biotechnology company, pharmaceutical company or other entity that owns the right to develop, market and commercialize the drug product will assign the right to the royalty stream generated by the drug product to a securitization entity established and maintained as an indirect subsidiary of such entity. This may involve a single drug product or multiple drug products (and may include the addition of additional drug products following the closing of the drug royalty securitization), which drug products may be at any stage of development, marketing or production when the right to the royalty streams is assigned to the securitization entity. Overcollateralization and other credit enhancement is provided in a manner similar to the media royalty securitizations described above. Drug products that have already been developed, marketed and commercialized successfully in the market offer more predictable revenue streams than those at an earlier stage of that process.

Royalty securitizations closed in 2018 included a repeat issuance by a drug royalty securitization vehicle for which the sponsor is a leader in the drug royalty securitization business. There have been no drug royalty securitizations in 2019 year to date, but we expect the asset class to continue to be used by targeted issuers.

### RECENT LEGAL DEVELOPMENTS & CONCLUDING REMARKS

The Supreme Court recently addressed the ability of a trademark licensee to continue to use trademarks following a bankruptcy of the licensor in its recent decision in *Mission Prod. Holdings, Inc. v. Tempnology, LLC*.<sup>3</sup> The Supreme Court's decision in *Mission* has important implications for royalty securitizations pursuant to which a securitization entity licenses the intellectual property rights in trademarks and other types of intellectual property that it owns to unaffiliated licensees in return for royalty payments.

In *Mission*, the Supreme Court held that a bankruptcy debtor's rejection of an existing trademark license agreement does not revoke a non-debtor licensee's right to continue using the trademark. The Supreme Court's decision is favorable to non-debtor licensees of trademarks in that it allows licensees to either continue using a trademark through the end of the



license term or to assert prepetition damage claims resulting from the rejection of the license. For a more detailed analysis of the Supreme Court's decision in *Mission* please see the K&S client alert [\*US Supreme Court Concludes Debtors May Not Terminate Trademark Rights of Licensees by Rejection in Bankruptcy, Resolving Circuit Split.\*](#)

Royalty securitizations typically involve securitization entities that own trademarks and other intellectual property rights that are licensed to franchisees or other unaffiliated licensees in return for royalty payments. Some have argued that to the extent that trademark licensees of a securitization entity continue to use licensed trademarks following a securitization entity licensor's rejection of such trademark license in a bankruptcy proceeding, the securitization entity licensor may be required to continue to enforce certain quality control and other covenants against the third party that are necessary to maintain the integrity of the licensed trademarks regardless of the rejection—something it may not have the wherewithal or resources to do during the pendency of a bankruptcy. We believe that this concern is allayed to great extent by the typical structuring of the securitization entities in a royalty securitization as special purpose, bankruptcy remote entities in order to prevent the consolidation of the securitization entities in a bankruptcy filing of one or more of its affiliated “above-the-line” non-securitization entities, a standard feature of whole business securitizations. Additionally, given that such licenses are a principal revenue stream of a securitization entity in a royalty securitization, we would expect it unlikely for a securitization entity to reject such a license in a bankruptcy proceeding in the first place absent very special circumstances. As such, we expect the *Mission* holding to have little (if any) negative impact to royalty securitizations in practice.

However, *Mission* may have other interesting implications for structuring royalty securitizations. The holding in *Mission* could be viewed to bolster an alternative and potentially more efficient and flexible method of structuring royalty securitizations for certain issuers. Instead of transferring underlying trademarks and other intellectual property rights wholesale into a securitization, these same intellectual property rights could be licensed from the non-securitization entities to the securitization entities, with the securitization entities then sub-licensing such rights to third parties in reliance on *Mission* that the securitization entities could continue to use the underlying intellectual property via license even after a bankruptcy of the non-securitization licensor. Such structures are certainly not without precedent in royalty securitization but are not nearly as commonplace as the traditional structure where the underlying intellectual property itself is transferred into the securitization and then licensed to third parties. Typically, such structures have been confined to the media and drug royalty spaces where intellectual property rights themselves are more static, but the *Mission* holding could provide additional assurance in structures involving actively-managed intellectual property, such as whole business or other operating asset securitizations where intellectual property is continually refined, managed and developed. We intend to monitor developments on this topic carefully as the market continues to develop different structures in the whole business and other esoteric asset securitizations.



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<sup>1</sup> As reported on [www.finsight.com](http://www.finsight.com) by Finsight Group, Inc.

<sup>2</sup> As reported on [www.finsight.com](http://www.finsight.com) by Finsight Group, Inc.

<sup>3</sup> See *Mission Prod. Holdings, Inc. v. Tempnology, LLC*, No. 17-1657, 2019 WL 2166392 (U.S. May 20, 2019) at \*9.