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# BOWIE BONDING IN THE MUSIC BIZ: WILL MUSIC ROYALTY SECURITIZATION BE THE KEY TO THE GOLD FOR MUSIC INDUSTRY PARTICIPANTS?

Teresa N. Kerr\*

## I. INTRODUCTION

Until recently, individuals in the music industry have been slow to tap into the financial resources that the capital markets provide. In order to get projects done, these “music industry participants” traditionally relied on their own savings, unfavorable bank loans, infamous music advances, or the next royalty check to roll in<sup>1</sup>

In 1997, singer/songwriter/publisher David Bowie scoffed at traditional music industry financing and struck gold in the capital markets by issuing the first ever asset securitization involving music royalty future receivables and intellectual property rights. The deal netted the artist \$55 million and began the music industry’s newfound love affair with the capital markets. It further sparked other industries that rely heavily on intellectual property rights to consider

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<sup>1</sup> Music industry participants refers to publishers, songwriters, and artists. Besides the record companies, these parties are the main players in the music industry and thus have a strong interest in the future success or failure of music royalty securitization transactions. A discussion of the impact music royalty securitization will have on record companies is beyond the scope of this comment. For more information on this issue, see Nicole Chu, *Bowie Bonds: A Key To Unlocking The Wealth of Intellectual Property*, 21 HASTINGS COMM. & ENT. L.J. 469, 488 (1999).

securitization as a viable financing tool for the future.

This comment provides an overview of the Bowie Bond transaction and the future of "individual music royalty securitizations."<sup>2</sup> Part II defines the asset securitization process in the capital markets. Part III discusses how asset securitization transactions in general are structured. Part IV analyzes a music royalty receivable securitization, with an in-depth discussion of the Bowie Bond transaction. Part V addresses the benefits and costs associated with a music royalty securitization. Part VI discusses whether the music royalty securitization market will flourish. Part VII contains concluding remarks.

## II. CAPITAL MARKET'S NEW FINANCING TOOL: ASSET SECURITIZATION

Asset securitization, commonly referred to as structured finance or simply securitization, is one of the most significant financial innovations of the last twenty years.<sup>3</sup> "Securitization has been a boon to virtually every participant in the capital markets, including: banks and other financial institutions looking for alternative sources of funds and fee income; borrowers seeking to lower their cost of funds by broadening their access to the capital markets; investment bankers generating income by underwriting, making markets in, and trading asset-backed securities; and investors preferring highly rated securities with greater protection from downgrading than traditional debt and

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<sup>2</sup> Individual music royalty securitization refers to the securitization of royalties belonging to an individual artist, songwriter, and/or publisher. This is in contrast to the collective securitization of the royalties from a variety of different talent in a process known as bundling. Bundling is more accessible to record companies that have a variety of successful artists that in the collective can generate a healthy royalty stream capable of asset securitization.

<sup>3</sup> See, e.g., Campbell, *Innovations in Financial Intermediation*, BUS. HORIZONS, Nov./Dec. 1989, at 70; See, also, ABA Section of Taxation, Committee on Fin. Trans., Subcommittee on Asset Securitization, *Legislative Proposal to Expand the REMIC Provisions of the Code to Include Nonmortgage Assets*, 46 TAX L. REV. 299, 343 n.160 (1990) (stating that the first publicly offered asset-backed security transaction occurred in 1985 when Sperry Lease Corporation issued \$192.5 million of its series A lease-backed notes).

often with greater yields than securities of comparable credit quality.”<sup>4</sup> Asset-backed securities is one of the fastest growing segments of finance on Wall Street.<sup>5</sup> As of 1995, \$119 billion in asset-backed securities were offered.<sup>6</sup> This rose to \$148 billion in 1996 and \$185.1 billion in 1997.<sup>7</sup> As of 1999, the U.S. asset-backed securities market was worth over \$200 billion and observers anticipate even greater growth for the millennium.<sup>8</sup> Indeed, due to this dramatic growth in the asset-backed securitization market, the Securities and Exchange Commission (the “SEC”) was forced to create a new office to handle the product and is planning to publish asset-backed securities registration forms to accommodate the regulation of these complex legal and financial vehicles.<sup>9</sup>

Although securitization is widely discussed in legal and financial literature, because no uniform definition has emerged that describes it satisfactorily, “securitization” has been used to mean a variety of different things.<sup>10, 11</sup> For purposes of this comment, “securitization” will be defined as “the sale of equity or debt instruments, representing

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<sup>4</sup> Joseph C. Shenker & Anthony J. Colleta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1372 (1991).

<sup>5</sup> Aaron Elstein, *If It Moves, David Pullman Might Securitise It*, AM. BANKER, Feb. 28, 1997, at 1.

<sup>6</sup> Aaron Elstein, *Issuance of Asset-Backed Securities Jumped to a Record \$148 B in Year*, AM. BANKER, Dec. 20, 1996, at 28.

<sup>7</sup> *Id.*; Karen Talley, *97 Asset-Backed Issues a Record \$185B*, AM. BANKER, Jan. 23, 1998, at 22K.

<sup>8</sup> John Willcock, *Stars Mine Gold From Rock of Wages*, THE INDEPENDENT, June 16, 1999, at 2.

<sup>9</sup> Jennifer B. Sylva, *Bowie Bonds Sold For Far More Than A Song: The Securitization of Intellectual Property As A Super-Charged Vehicle for High Technology Financing*, 15 COMP. & HIGH TECH. L.J. 195, 199 (1999).

<sup>10</sup> See J. HENDERSON & J. SCOTT, *Securitization 1* (1988) (noting that journalists have seized upon the word “securitization” and invested it with numerous shades of meaning, some of which are misleading); see also Bonsall, *Legal Aspects of Securitisation*, Euromoney, Aug. 1989 (Supp.), at 7 (noting that securitization is not a legally defined term).

<sup>11</sup> An in-depth discussion of the various definitions of asset securitization is beyond the scope of this comment. See, e.g., Shenker & Colletta, *supra* note 4, at 1373-6 (providing a more comprehensive discussion of the definitions of securitization).

ownership interests in, or secured by, a segregated, income-producing asset or pool of assets, in a transaction structured to reduce or reallocate certain risks inherent in owning or lending against the underlying assets and to ensure that such interests are more readily marketable and, thus, more liquid than ownership interests in and loans against the underlying assets.”<sup>12</sup>

Securitization is essentially a technique firms use to raise financing.<sup>13</sup> In securitization transactions, a firm (“the originator”) sells its rights to receive certain future monies (“receivables”) to a newly created entity, generally known as a special purpose vehicle (“SPV”).<sup>14</sup>

The SPV then issues bonds to investors to generate present cash flow for the originator.<sup>15</sup> In return, the investors receive interest and principal back from the income stream of the receivables which are now held by the SPV.<sup>16</sup> The originator can then utilize the present cash flow to run its business or to generate further receivables that can be pledged to a traditional asset-based lender.

Purchasers of SPV securities may be institutional investors (such as pension funds, insurance companies, and mutual funds) or sometimes, individuals.<sup>17</sup> The investors have first rights on that income, regardless of what happens to the issuer setting up the SPV.<sup>18</sup> Despite the essential simplicity of the concept, in practice these deals can be extremely complex and costly to arrange.<sup>19</sup> Therefore, a brief summary of asset-backed securitization transactions follows.

### III. STRUCTURING AN ASSET-BACKED SECURITIZATION

Structuring a traditional asset-backed securitization is a multi-step

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<sup>12</sup> Claire A. Hill, *Securitization: A Low-Cost Sweetener For Lemons*, 74 WASH U. L.Q. 1061, 1063 n.5 (1996).

<sup>13</sup> “Firm” is used generically to mean an entity, whether a corporation, partnership, or other organizational form, which wishes to raise funds.

<sup>14</sup> Janet Lewis, *Bankers Turn to More Exotic Territory*, FIN. NEWS, November 9, 1998.

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

<sup>17</sup> Hill, *supra* note 12, at 1067-1068.

<sup>18</sup> Lewis, *supra* note 14.

<sup>19</sup> *Id.*

process. First, the assets are identified and valued. Second, a SPV is created. Third, the assets are transferred to the SPV in the form of a “true sale”.<sup>20</sup> Then the SPV issues the asset-backed securities to investors. Finally, a plan for “servicing” the assets and repaying the bondholder is established.<sup>21</sup>

#### A. *Step One: Identification of the Assets*

Any asset that can provide a consistent stream of income or that can be converted into a predictable amount of cash can be securitized.<sup>22</sup> Examples of assets that have been securitized include credit card receivables, lease receivables (including automobile, equipment, and aircraft leases), commercial loans, insurance premiums, mortgages, and loans to small businesses.<sup>23</sup>

An asset is ideal for securitization if it generates a steady stream of income in the form of a payment obligation from a third party that is sufficient enough to cover the distribution of income to the asset-backed securities, all administrative expenses associated with structuring the deal, as well as the default risk for the entire portfolio of secured assets.<sup>24</sup>

In addition, the assets must be clearly identifiable and severable from the assets of the originator.<sup>25</sup> This is especially important if the originator retains the role of servicing the securities because it further

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<sup>20</sup> A “true sale” is a sale by the originator of its title in the assets that are to be securitized by the SPV, thereby establishing the SPV as a completely independent entity from the originator. For further discussion, see *infra*, Part III, Section C.

<sup>21</sup> “Servicing” means is to establish a system after the securities have been issued to collect the periodic payments on the receivables and forward this amount to the SPV, so that that the bondholders can be repaid. For further discussion, see *infra*, Part III, Section E.

<sup>22</sup> The Committee on Bankr. and Corp. Reorg. of the Assoc. of the Bar of the City of New York, *Structured Financing Techniques*, 50 BUS. LAW 527, 532 (1995).

<sup>23</sup> Hill, *supra* note 12, at 1076-1077.

<sup>24</sup> Stephen L. Schwarcz, *The Alchemy of Asset Securitization*, in NEW DEVELOPMENTS IN SECURITIZATION, (PLI Com. Prac. Handbook Series Nos. 704, 515, 519 (1994)).

<sup>25</sup> *Id.* (explaining that the entity that owns the assets before the securitization is called the originator); See Sylva, *supra* note 9, at 210.

insulates the originator from risks of consolidation upon completion of the transaction.

Moreover, the financier must take into consideration the regularity at which payments are disbursed on the assets.<sup>26</sup> For instance if the assets are credit card receivables, payments on the assets are regularly conducted on a monthly basis and thus are predictable. If the payments on the assets are predictable, the assets will receive a higher valuation from the “rating agencies”.<sup>27</sup>

Lastly, the aggregate rate of default also impacts on the identification of the assets. If the aggregate default rate is predictable, then assets or receivables that present some risk of default may also be securitized.<sup>28</sup> In determining the default rate, one should also consider whether the pool of receivables is due from many obligors or merely one source. A diversified pool of obligors minimizes the risks associated with asset-backed securitization and is therefore preferable for an asset-backed securitization transaction.<sup>29</sup>

Consequently, in identifying an asset’s potential for securitization, one must consider the extent to which the asset can provide a consistent stream of income, the duration of that income, the severability of the asset, as well as the aggregate default rate on the asset.

#### B. *Step Two: Creation of the SPV*

In a typical asset-backed securitization the assets are isolated from the originator in order to sever the assets from any risks associated with the originator.<sup>30</sup> Since investors in asset-backed securities rely solely on the income from the assets for the repayment of their investment, they do not want the creditors of the originator to be able to seize these assets in the event of the originator’s default. Therefore, a SPV is

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<sup>26</sup> Schwarcz, *supra* note 24, at 519

<sup>27</sup> Rating agencies assign a rating to the debt instruments offered by issuer after reviewing the terms of the transactions and the creditworthiness of the issuer. For further discussion, see *infra*, Part III, Section D.

<sup>28</sup> Sylva, *supra* note 9, at 210.

<sup>29</sup> Schwarcz, *supra* note 24, at 519.

<sup>30</sup> Marsha E. Simms, *Asset Securitization*, in ASSET-BASED FINANCING (PLI Com. Prac. Handbook Series No. A4-4518, 335, 338-341 (1997)).

created for the purpose of isolating the assets that are to be securitized from the originator.<sup>31</sup>

A SPV may be a trust, corporation, limited liability partnership, or any other legal entity that may suit or achieve the funding objectives.<sup>32</sup> The form of the entity is dependent on the needs of the originator and the specifics of the transaction.<sup>33</sup> The most common SPV is the corporation.<sup>34</sup> However, due to issues of double taxation, the corporation may not be appropriate for all transactions.<sup>35</sup> Therefore, one must consider the specific facts of the particular transaction when creating a SPV.

In order to purchase the assets from the originator, the SPV will need to raise capital.<sup>36</sup> The SPV raises capital from investors by borrowing using conventional loan techniques, such as issuing notes and bonds in the capital markets.<sup>37</sup> To achieve the confidence of investors, the SPV will therefore need to be constructed to be "bankruptcy remote".<sup>38</sup> If the SPV is bankruptcy remote, it will not be subject to the originator's creditors in the event that the originator becomes bankrupt.<sup>39</sup> However, bankruptcy remote does not necessarily mean bankruptcy proof.<sup>40</sup> A bankruptcy remote SPV simply means that the SPV is less likely to be adversely affected by the originator's bankruptcy.<sup>41</sup> To achieve bankruptcy remote status, rating agencies require that the SPV's charter or other organizational documents contain provisions that limit the ability of the SPV to become bankrupt. These provisions, among other things, specify that

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<sup>31</sup> Sylva, *supra* note 9, at 21.

<sup>32</sup> Simms, *supra* note 30, at 338-341.

<sup>33</sup> Sylva, *supra* note 9, at 217.

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

<sup>36</sup> *Id.* at 218.

<sup>37</sup> Managing Property, *Securitization: Exploring The Financial Markets*, <visited December 11, 1999>, [www.lawmoney.com](http://www.lawmoney.com); For further discussion of issuance of asset-backed securities, see *infra*, Part III, section D.

<sup>38</sup> Sylva, *supra* note 9, at 218.

<sup>39</sup> *Id.*

<sup>40</sup> See Committee on Bankr. & Corp. Reorg. of the Assoc. of the Bar of the City of New York, *supra* note 17, at 584.

<sup>41</sup> Sylva, *supra* note 9, at 218.



the activities of the SPV are limited to this particular securitization transaction, limits the debt that the SPV can incur, prohibits mergers or consolidations with other entities unless the surviving entity is also bankruptcy remote, and places limitations on the SPV's right to file for bankruptcy, dissolve, liquidate or sell all of its assets, engage in any other business activity, or amend its organizational documents.<sup>42</sup> As a result of these provisions, third party creditors besides the holder of the asset-backed securities, will not be able to file an involuntary bankruptcy petition against the SPV.

### C *Step Three: Transfer of Assets to the SPV*

After the SPV is created, the originator's isolated and valued assets are sold to the SPV. The form of the sale of the assets is of primary importance because it determines whether or not the SPV would be insulated in the event of the originator's bankruptcy.<sup>43</sup> There must be a true sale of the assets to the SPV in order for the SPV to be insulated in the event of the originator's bankruptcy. A true sale is a sale by the originator of its right, title, and interest in the assets that are to be securitized by the SPV.<sup>44</sup>

Courts consider several factors in determining if a true sale has occurred. These factors include: (1) the intent of the parties, (2) whether a transfer of the risks and benefits of the ownership of the assets has occurred, (3) whether the SPV and its investors bear the risk of loss if anything should happen to the assets, (4) whether the benefits of ownership appear to be retained by the originator because the originator may repurchase the assets by paying the purchase price, (5) whether the documentation provides that the originator services the transferred assets, (6) whether there was a fixed purchase price, (7) whether there was compliance with the Uniform Commercial Code ("U.C.C.").<sup>45</sup> As long as the originator has not retained or assumed a

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<sup>42</sup> *Id.* at 219.

<sup>43</sup> Meredith S. Jackson, *Leap of Faith: Asset-Based Lending to Asset-Backed Securitization: A Case Study*, 2 STAN. L.J. BUS. & FIN. 193, 197 (1995).

<sup>44</sup> Larry G. Engel & Andrew B. Koslow, *Securitization Advice for Asset-Based Lenders*, in ASSET BASED FINANCING (PLI Com. Prac. Handbook Series No. A-708, 471, 481-485 (1995)).

<sup>45</sup> *Id.* at 480.

significant portion of the risk that there will be a loss suffered on the assets, the transaction should qualify as a true sale.

If a balancing of these factors does not suggest that a true sale has occurred, a court may find that the transfer of assets is merely a collateralized loan made to the originator.<sup>46</sup> As such, the transfer of assets will be viewed as collateral by the originator and in the event of bankruptcy the assets would be consolidated as part of the originator's estate.<sup>47</sup> Moreover, under the equitable "doctrine of substantive consolidation," a bankruptcy court has the power in a bankruptcy proceeding involving "one or more related corporate entities to disregard the separateness of the corporate entities and consolidate and pool the entities assets and liabilities and to treat them as though held and incurred by one entity."<sup>48</sup> As a result, the separateness of the SPV will be ignored and the SPV may be exposed to bankruptcy if the originator faces bankruptcy.

To guard against this risk of substantive consolidation, it is therefore necessary to perfect a security interest in the assets upon transfer.<sup>49</sup> According to the U.C.C., a security interest is "an interest in personal property or fixtures, which secures payment or performance of an obligation."<sup>50</sup> Perfection is the process used to provide notice to the rest of the world that the creditor's security interest in the collateral is superior to the interests of any subsequent creditors.<sup>51</sup> Although

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<sup>46</sup> Malcolm S. Dorris & Edward J. O'Connell, *Problem Cases in Bankr.*, in NEW DEVS. IN SECURITIZATION (PLI Com. Prac. Handbook Series No. A-732, 99, 107 (1995)).

<sup>47</sup> *Id.*

<sup>48</sup> Simms, *supra* note 30, at 350; Note: Substantive consolidation is not derived from any specific provisions of the Bankruptcy Code, but rather equitable principles applied by courts. The law is still evolving in this area, but courts have relied on three different tests to determine whether consolidation is warranted. See Scott A. Stengel, *On The Edge: Substantive Consolidation And The Need for Business Bankruptcy Expertise In The Booming Economy*, 1998 ABI JNL. Lexis 179, September 1998 (providing a complete discussion of the doctrine of substantive consolidation and of tests applied by the courts).

<sup>49</sup> Simms, *supra* note 24, at 373-376.

<sup>50</sup> U.C.C. § 1-207(37).

<sup>51</sup> RUSSELL A. HAKES, THE ABC'S OF THE U.C.C. ARTICLE 9: SECURED TRANSACTIONS 8, at 25.

perfection does not assure priority over all third party claims, it increases the chances of establishing priority. As a result, the bondholder is reassured by knowing that creditors of the SPV or the originator may not interrupt the flow of income to the bondholder by making claims against the assets.

Article 9 of the U.C.C. applies to “any transaction which is intended to create a security interest in personal property or fixtures.”<sup>52</sup> In order to perfect a security interest, the property must be attached and notice must be provided.<sup>53</sup> A security interest attaches when all of the following has been met: (1) the collateral is in the possession of the secured party or the debtor has signed a security agreement containing a description of the collateral, (2) value has been given by the secured party, and (3) the debtor has rights in the collateral.<sup>54</sup> Once the security interest is attached, notice must be provided to third parties in order to fully perfect the secured parties’ interest in the collateral. This can be accomplished by either filing a financing statement in the state of the debtor’s principal place of business, taking possession of certain types of collateral, or via automatic perfection in situations where notice would be deemed impractical or unnecessary.<sup>55</sup>

Therefore, in order to properly transfer the assets to the SPV, the bondholder must make sure a true sale has occurred and that the security interest has been perfected.

#### D. *Step Four: Issuing of Asset-Backed Securities*

The issuance of securities involves the actual issuance of securities, the rating of the securities, and the credit enhancement.<sup>56</sup> The actual bond issuance requires extensive paperwork opinion letters from lawyers, documents duly filed with the state, the authentication of the debenture, and the assignment forms, and therefore is generally costly.<sup>57</sup>

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<sup>52</sup> U.C.C. § 9-102(1).

<sup>53</sup> U.C.C. § 9-203.

<sup>54</sup> Simms, *supra* note 30, at 375.

<sup>55</sup> U.C.C §§ 9-402(1), 9-302, 9-305, 9-303.

<sup>56</sup> Sylva, *supra* note 9, at 225.

<sup>57</sup> *Id.*; Lewis, *supra* note 14.

### 1. The Securities Act of 1933 (“the 1933 Act”)

A securitization transaction can take the form of either a public offering of securities that are registered with the SEC pursuant to the 1933 Act or a private placement that makes use of one of the exemptions to the Act.

A public offering of securities widens the range of potential investors that can purchase the securities. However, the 1933 Act imposes strict standards of disclosures on the issuer and requires the filing of a registration statement with the SEC in connection with any public offering of nonexempt securities.<sup>58</sup> Issuers can also be held liable for certain types of fraudulent statements and omissions contained in the registration materials.<sup>59</sup> In addition, registration can take several months to complete and is extremely costly.<sup>60</sup> For these reasons, a public offering may not be appropriate for all transactions.

If this is the case, the investor may elect instead to issue its securities in a private placement under section 4(2) of the 1933 Act, which exempts from registration “transactions by an issuer not involving any public offering.”<sup>61</sup> Private placements are generally done when there is a small pool of assets or when the issuer is confident it can sell the securities to a relatively small number of institutional investors. If the private placement is made to a few large institutional investors very little is required in the way of specialized disclosure documents, because it is assumed these individuals have the sophistication to make an informed investment decision.<sup>62</sup> However, if the private placement is to a larger number of investors or to non-institutional investors, the issuer should comply with the “safe harbor” clause contained in Regulation D (“Reg. D”) to avoid the SEC filing requirement.<sup>63</sup> Under Reg. D, the SPV can sell its securities to up to thirty-five non-accredited investors and a unlimited number of

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<sup>58</sup> 1933 Act §§ 7, 10, 5(c).

<sup>59</sup> Steven L. Schwarcz, *Structured Finance: A Guide To The Principles of Asset-Securitization* (PLI Com. Handbook Series No. A1-1418, 61-62 (1993)).

<sup>60</sup> *Id.* at 62.

<sup>61</sup> 1933 Act §4(2).

<sup>62</sup> Schwarcz, *supra* note 59, at 62.

<sup>63</sup> 17 C.F.R. §§ 230.501-506.

“accredited investors” without having to deal with overly burdensome registration requirements.<sup>64</sup>

In addition, Rule 144A further exempts certain sales of securities made to “qualified institutional buyers” from the registration requirements of the 1933 Act. A qualified institutional buyer is any entity that in the aggregate owns or invests on a discretionary basis at least \$100 million in securities of issuers not affiliated with the entity.<sup>65</sup> If the sale of the securities is to a qualified institutional buyer, the buyer is aware that the exemption is being invoked, and the issued securities is different from any other securities listed on a national exchange or quotation system, the Rule 144A exemption is applicable.<sup>66</sup> Most purchasers of asset-backed securities, are indeed institutional buyers, thus the Rule 144A exemption can usually be applied to the transaction.

After the issuer decides whether to have a public or private placement of the securities, it must decide what type of securities to issue. The SPV securities can take many forms. They can be debt (senior or subordinated), equity (in one or more classes), or debt or equity payable only from the principal, or interest, on the receivables.<sup>67</sup> The debt can be long or short term, and it can carry a fixed or floating interest rate.<sup>68</sup> The equity also can have a stated interest rate.<sup>69</sup> The debt is an obligation of the SPV, secured by the SPV’s assets, the receivables of the originator.<sup>70</sup> The equity represents an interest in the SPV’s assets.<sup>71</sup>

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<sup>64</sup> 17 C.F.R. §230.501(a) (Note: that in addition those parties that fit within the definition of an institutional investors, the definition of accredited investors also includes individuals with a net worth of \$1million or more and corporations with total assets in excess of \$5 million).

<sup>65</sup> Schwarcz, *supra* note 59, at 63, fn. 160.

<sup>66</sup> Simms, *supra* note 26, at 368.

<sup>67</sup> Hill, *supra* note 12, at 1086.

<sup>68</sup> *Id.*

<sup>69</sup> *Id.*

<sup>70</sup> *Id.*

<sup>71</sup> *Id.*

## 2. Rating Agencies

In order to attract investors, these securities must be rated by a rating agency, such as Standard & Poor's Rating Group, Duff & Phelps, or Moody's Investors Services.<sup>72</sup> "Creating an efficient interface between investors and issuers, rating agencies assist capital markets by, first, reducing individual investor's information costs in conducting their own securities research and, second by reducing the cost of capital paid by issuers."<sup>73</sup> The rating agency examines both the structure of the transaction as well as the capital structure and overall creditworthiness of the issuer in order to assign a category of risk of a default in payment of principal and interest due on the securities. Credit ratings are opinions provided by the rating agencies about the absolute credit risk of default of payment on the security and the relative credit risk vis-à-vis other categories of ratings.<sup>74</sup> Credit ratings are not recommendations to enter securities transactions.<sup>75</sup>

There are many possible ratings. The highest-rated debt is virtually certain, in the rating agency's estimation, to be timely and fully repaid in accordance with its terms.<sup>76</sup> Conversely, the lowest-rated debt is significantly less likely to be timely and fully repaid. Investors and issuers alike value a higher credit rating because investors are more confident they will be repaid and issuers can receive a lower rate of interest on the debt.<sup>77</sup> The credit rating of the SPV is totally independent of that of the originator. The SPV securities will receive the highest rating if the pro forma payment of royalties to the SPV is steady, dependable, and could support interest payments on the issuance of the bond.<sup>78</sup>

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<sup>72</sup> Sylva, *supra* note 9, at 226.

<sup>73</sup> Amy K. Rhodes, *The Role of the SEC in the Regulation of the Rating Agencies: Well-Placed Reliance Or Free-Market Interference?*, 20 SETON HALL LEGIS. J. 293, 294 (1996).

<sup>74</sup> *Id.* at 302.

<sup>75</sup> Sylva, *supra* note 9, at 226.

<sup>76</sup> Hill, *supra* note 12, at 1071.

<sup>77</sup> *Id.*

<sup>78</sup> Sylva, *supra* note 9, at 227.

Most rating agencies charge the issuer a fee for the rating service.<sup>79</sup> The charges usually vary depending on the size and complexity of the issue. In 1996, for example, a new long-term corporate bond issue ranged from two to three basis points of the principal for each year the rating was maintained.<sup>80</sup>

### 3. Credit Enhancements

The use of a credit enhancement can lead to a higher credit rating.<sup>81</sup> A credit enhancement guarantees that all payment obligations are fulfilled on time, minimizing the risk of default.<sup>82</sup> The greater the guarantee of the bond reaching its maturity without a default of payments, the greater the likelihood of attracting a high credit rating.<sup>83</sup> In addition, the credit enhancement also protects the originator's assets from default in payment by creating alternate lines of credit.<sup>84</sup>

There are two types of credit enhancements. An internal credit enhancement is created by the SPV or the originator and may appear in the form of a cash reserve account.<sup>85</sup> External credit enhancements are provided by an outside source, such as a bank.<sup>86</sup> External credit enhancements tend to be more costly due to bank fees charged for services such as letters of credit, financial guarantees, and default insurance.<sup>87</sup> Therefore, if an external credit enhancement is used, the fees must be included in the overall administrative costs of the transaction that the future receivables must cover.<sup>88</sup>

#### E. *Step Five: Servicing the Assets*

After the securities are issued, a servicer is arranged to ensure that the assets are monitored and collected and the receivables plus interest

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<sup>79</sup> Rhodes, *supra* note 73, at 308.

<sup>80</sup> *Id.*

<sup>81</sup> Sylva, *supra* note 9, at 227.

<sup>82</sup> *Id.* at 228.

<sup>83</sup> *Id.*

<sup>84</sup> *Id.*

<sup>85</sup> *Id.*

<sup>86</sup> *Id.*

<sup>87</sup> *Id.*

<sup>88</sup> *Id.*

are paid to the SPV, who then repay the bondholders.<sup>89</sup> The servicer can be the originator or a third party contracted specifically to perform the servicing function.<sup>90</sup> Although it is customary for the originator to service the receivables of the SPV, retention of such a role by the originator poses question as to whether a true sale actually occurred.<sup>91</sup> Therefore, if the originator assumes this role, it is necessary that the same standards are adhered to in servicing the assets as if the servicer was a third party.<sup>92</sup> The servicer charges a small fee for servicing the assets and deducts this amount before the receivables and interest are given to the SPV.

#### IV. MUSIC ROYALTY SECURITIZATION: BOWIE BOND BREAKDOWN

In February 1997, David Bowie<sup>93</sup> struck gold with a \$55 million securitization of the royalty rights from more than two hundred and fifty of his songs.<sup>94</sup> The Bowie Bonds, as they came to be known, have an average ten year duration and a 7.9 percent coupon, beating the normal return on most asset-backed securities by at least half a point.<sup>95</sup> The Bowie deal is noteworthy because it is the first ever securitization of music recording and publishing rights.<sup>96</sup> It is also the first securitization of any privately held intellectual property rights.<sup>97</sup>

Due to the success of the Bowie Bonds, songwriters, authors, actors, clothing designers, and even athletes around the world are

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<sup>89</sup> Lois R. Lupica, *Asset-Securitization: The Unsecured Creditor's Perspective*, 76 Tex. L. Rev. 595, 600 (1998).

<sup>90</sup> *Id.* at 601, fn. 17.

<sup>91</sup> Sylva, *supra* note 9, at 229.

<sup>92</sup> *Id.*

<sup>93</sup> David Bowie has been performing since the 1960s. He has collaborated and performed with such legends as Bing Crosby and John Lennon. See [www.davidbowie.com](http://www.davidbowie.com), for more information on David Bowie.

<sup>94</sup> *Bowie Ch-Ch-Changes the Market*, CFO: the Magazine for Senior Financial Executives, Apr. 1, 1997, 1997 WL 8300101.

<sup>95</sup> Sam Adler, *Bowie Breakthrough: Structuring Music Bonds Issue*, ENT. L. & FIN., Sept. 1997, at 1.

<sup>96</sup> CFO, *supra* note 94.

<sup>97</sup> *Id.*



exploring the possibilities of asset-backed securitization.<sup>98</sup>

A. *Identifying the Assets in a Music Royalty Securitization*

The most important step in a music royalty securitization, as with any asset-backed securitization, is identification of the asset to be securitized. The assets must display a significant revenue-generating history in order to be securitizable.<sup>99</sup>

In particular, investors need to know what is being securitized and what does owning the assets entitle the SPV to do and for how long.<sup>100</sup> The historical cash flows should show earning stability over a number of years and ideally demonstrate an upward trend.<sup>101</sup> Debt will have to be serviced for a term of ten to twenty years in typical royalty securitization, so cash flows can not be generated by a “one hit

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<sup>98</sup> Ross A. Snel, *New Bowie Bonds Bank On Royalties From Motown Trio*, Wall St. J., April 29, 1998, at C24 (Edward Holland, Lamont Dozier and Brian Holland, Motown hit song writers who are credited with works such as “Stop! In the Name of Love” recently signed a \$30 million royalty-backed securitization); Ann Brown., *Royalties ‘R’ US*, Black Enter., June 1999, at 39 (songwriters Ashford and Simpson just secured \$25 million in bonds with their future royalties for a catalog including such songs as “Reach Out & Touch Somebody’s Hand”); David Henry, *Brown’s Brand-New Bag: \$30 M Loan on Royalties*, USA Today, June 16, 1999, at 1B (James Brown receives \$30 million for up to 20 years secured by future royalties on his 750 titled catalogue); Keith J.Kelly, *Bonds Could Raise \$100M to Backo Jacko*, New York Post, November 18, 1998, at 34 (Michael Jackson, Bing Crosby, Stills & Nash, and Rolling Stones are considering securitization deals); ‘*Seinfeld*’ *Going Wall Street? Yada Yada Yada*, Nando Times News, <visited March 20, 2000>, www.techserver.com (Suggesting television syndication securitizations may be in the future for actors such as Seinfeld); Akil Salim Roper, *Entertainment ABS Seeks to Break New Ground*, Private Placement Letter, October 4, 1999 (Suggesting that literary writers like the author of Dr. Seuss and clothing manufacturers such as Hugo Boss and Pierre Cardin are prime targets for an asset securitization); Richard Wilner, *Batter-Up For Frank Thomas Bowie Bonds*, NY Post, August 7, 1998 (Suggesting that Frank Thomas may lead the path for the first securitization of baseball contracts).

<sup>99</sup> Duff & Phelps Credit Rating Company, *Asset Backed Securities: DCR Comments on Music Royalty\_Securitizations*, <visited on December 10, 1999> www.dcrco.com.

<sup>100</sup> *Id.*

<sup>101</sup> *Id.*

wonder” with a short shelf life.<sup>102</sup>

The assets securitized in music royalty securitizations generally consist of the cash flow streams generated from ownership interests in copyrights related to a catalog of songs.<sup>103</sup> Pursuant to the Copyright Act of 1976 (the “Copyright Act”), the owner of a copyright holds the following exclusive rights in any “original work of authorship”: (1) reproduction, (2) preparation of derivative works, (3) distribution, (4) public performance, and (5) public display.<sup>104</sup> A musical work contains two different copyrights, one in the “musical composition” and the other in the “sound recording.”<sup>105</sup> Therefore, the owner of the musical composition is entitled to all the exclusive rights contained in section 106 of the Copyright Act, and the owner of the sound recording in the musical work is also entitled to the same rights. This ownership of the copyright in any part of the musical work not only allows the holder the right to exploit the music, it entitles him to receive royalty income from various parties for its use.<sup>106</sup> Since music copyrights include a bundle of rights that are exploited in many different ways by different parties, diverse and sometimes overlapping royalty income can be generated for the parties holding the copyright.<sup>107</sup>

The copyrights in a musical work can be owned by a variety of different parties. The ownership can be owned or even shared between the songwriter, performer, publisher, record company or manager.<sup>108</sup> The most fundamental interests in the music work, however, belongs to the party holding a copyright in the musical composition.<sup>109</sup> This tends

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<sup>102</sup> *Id.*

<sup>103</sup> *Id.*

<sup>104</sup> 17 U.S.C. § 106.

<sup>105</sup> Randy S. Kravis, *Does A Song By Any Other Name Still Sound As Sweet?: Digital Sampling And It's Copyright Implications*, 43 Am. U.L. Rev. 231, 240 [explaining that a record contains two separate copyrights one in musical composition (the actual musical notes on paper) and the other in the sound recording (the work that results from the fixation of sounds on a material object such as a disk, tape, or other phonorecord)].

<sup>106</sup> Duff & Phelps Credit Rating Company, *supra* note 99.

<sup>107</sup> *Id.*

<sup>108</sup> *Id.*

<sup>109</sup> *Id.*

to be the publisher, but in some situations may be the songwriter.<sup>110</sup> Publishers distribute the songs written by the songwriter. Music publishing contracts may be made for a single song or cover all material written by a songwriter for a term of years.<sup>111</sup> Regardless of the type of music publishing contract, it is commonplace for the music publisher to retain ownership of the copyrights of all songs a writer transfers to it for the life of the copyright, without a reversion of the copyright to the songwriter at the end of the contract period.<sup>112</sup> If the writer is under contract with a major record label or has some negotiating power, the music publisher may sometimes retain the copyright for only a specified term of years.<sup>113</sup> This, however, is rare.<sup>114</sup>

As the owner of the copyright in the musical composition, the publisher generally, has the exclusive right to exploit the musical composition by licensing, selling, or renting the musical composition to others. Publishing royalties are consequently generated every time the song is sampled, used in a commercial, or played on television or radio. These publishing royalties are distributed to the publisher, who keeps a share for himself and distributes the remaining share to the writer.<sup>115</sup> If the songwriter and publisher are the same person, that

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<sup>110</sup> Note: Songwriters and publishers are entitled to a share of publishing royalties, performance royalties (payments from radio and television that broadcast or use songs owned or written by member of the performance rights societies like ASCAP and BMI), and synchronization royalties (payments for when a song owned or composed is synchronized to a film or videotape, regardless of who performs it); Publishers are also entitled to mechanical royalties (monies paid by record companies to publishers for the right to use songs on records regardless of whether they are original or cover versions); Artists only receive payments under their contracts with record companies based on record sales. These are their only source of royalties if they are not also the songwriter or publisher.

<sup>111</sup> Sylva, *supra* note 9, 202.

<sup>112</sup> *Id.*

<sup>113</sup> *Id.*

<sup>114</sup> *Id.*

<sup>115</sup> Duff & Phelps Credit Rating Company, *supra* note 98. Note: While songwriters and co-producers are entitled to share in the royalties, the publisher gets to dictate the actual catalog's usage (how to exploit the music) if he owns the copyright in the musical composition. The publishers often sign licensing contracts with the record companies to license the work. As part of the contract, the record

individual is entitled to all the publishing royalties. Similarly, if there are co-writers and co-publishers, all royalties have to be distributed accordingly.

Since the assets in a music royalty securitization can be, among other things, the actual copyrights in the musical works, agreements between the writers and publishers regarding the writer's share of publishing rights, the publishing rights themselves, or record masters, an important part of the identification process is tracing and monitoring all royalty streams.<sup>116</sup> Of primary importance is the determination of which individuals or companies are parties to these agreements and what their relationships are to each other.<sup>117</sup> More specifically, financiers must ensure that the party seeking to be the originator in the securitization even has a right to receive the royalty payments from the assets.<sup>118</sup> In addition, they must determine if the seller has any restrictions on the sale of the assets pursuant to any agreements it may be a party to.<sup>119</sup> Financial analysts contend that if these factors are not present, it would be difficult if not impossible for the asset securitization to take place.<sup>120</sup>

Another aspect of the identification process is determining what entitlements the assets will provide the SPV and for how long. In order for a music royalty securitization to take place, the SPV should be entitled to benefit from the copyrights during the entire term of the transaction.<sup>121</sup> Therefore, the legal right to exploit the intellectual property must not either expire by law or by contract prior to the maturity of the transaction.<sup>122</sup>

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company generally obtains ownership of the record master to the studio recording of a rendition of a song. The owner of the record master can exploit and package it in whatever manner it chooses. The publisher is entitled to mechanical royalties from the record master and the artist may receive artist royalties if they so contracted with the record company.

<sup>116</sup> *Id.*

<sup>117</sup> *Id.*

<sup>118</sup> *Id.*

<sup>119</sup> *Id.*

<sup>120</sup> *Id.*

<sup>121</sup> *Id.*

<sup>122</sup> *Id.*

With regard to the Bowie deal, the assets used to securitize the \$55 million bond were the royalty income generated by the copyrights, music publishing licenses, and record sales from Bowie's twenty-five record catalogue of his earlier works.<sup>123</sup> Bowie had composed, recorded, and performed the majority of his music by himself.<sup>124</sup> As songwriter, performer, and publisher, Bowie had the right to collect all royalties for the use of his work, without having to share with other parties. In addition, unlike many recording artists,<sup>125</sup> Bowie had retained ownership of the record masters and copyrights to the majority of his back catalog of music, which dated back to 1960.<sup>126</sup> Since Bowie retained ownership of the copyrights to his musical works, he possessed the exclusive right pursuant to section 106 of the Copyright Act to receive royalty payments for the use of his work. In addition, since he was predominately a solo-artist and solo-composer, there were few third parties with whom Bowie was obligated to share royalties with. Indeed, the titles to the copyrights had been traced and no outstanding disputes were found because the royalty checks had all been issued and distributed to the same address for thirty years.<sup>127</sup>

It also appears that Bowie was not restricted by contract to sell his rights to the future royalty receivables. Moreover, the Copyright Act has recently been amended to extend the duration of a copyright for the life of the author plus seventy years.<sup>128</sup> As such, even following Bowie death's, Bowie's heirs or devisees will be entitled to receive royalty payments for any use of his copyrighted materials for seventy years thereafter. Therefore, neither by contract nor by law would the SPV's right to receive royalty payment terminate prior to maturity of the

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<sup>123</sup> Dominic Bencivenga, *Bowie Bonds: Pioneer Deal Uses Copyright to Raise Capital*, N.Y.L.J., May 15, 1997, at 5; Sam Adler, *Bowie Bond Buyer Explains Investment*, ENT. L. & FIN., Sept. 1997, at 6.

<sup>124</sup> Adler, *supra* note 95.

<sup>125</sup> Sylva, *supra* note 9, at 200 (suggesting that many artists are forced to assign the ownership of their copyrights to record companies and music publishers, particularly so in the early stages of their career when he or she has little power in negotiating a record deal).

<sup>126</sup> Bencivenga, *supra* note 123.

<sup>127</sup> Adler, *supra* note 95.

<sup>128</sup> *Disney Led Push To Add 20 Years to Copyright*, L.A. TIMES, October 18, 1998, at A18.

bond, which was scheduled for fifteen years.

Lastly, the income from the royalty stream from the copyrights, licenses, and sales of Bowie's music was also predictable enough to warrant securitization. Bowie consistently sells one million compact disks, cassettes, albums, and singles per year around the world.<sup>129</sup> Bowie's catalog of musical compositions has existed for the past twenty to thirty years, providing a well documented performance record for investors to predict whether the cash flow would continue in order to fully pay off the bond at maturity.<sup>130</sup>

Thus, the royalty from Bowie's music catalogue was an ideal asset for securitization.

#### B. *Creation of SPV and the Transfer of Assets To The SPV*

As with other asset securitizations, in order to securitize the royalty receivables, the ownership interest in the assets has to be transferred to a bankruptcy remote SPV via a true sale.<sup>131</sup> Bowie, the originator, therefore had to transfer his rights to this royalty and licensing income into a special purpose trust for the duration of the bond issue.<sup>132</sup> The transfer to the trust, removed the assets from Bowie's personal estate, protecting the investors in the event of the artist's bankruptcy.

The transfer of assets to the newly formed special purpose trust was structured as a true sale. However, just in case a court would find the transfer to be a collateralized loan and not a true sale, the SPV was given a first priority perfected security interest in the assets for the benefit of the bondholders. In order to obtain a first priority perfected security interest, the assets were attached and notice was given to third party creditors. The attachment of the assets occurred when: (1) the royalty and licensing rights were turned over to the SPV, (2) the assets were assigned a value of \$55 million, and (3) financiers concluded that Bowie had clear title to the royalty receivables. In order to provide

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<sup>129</sup> Jay Mathews, *Securities Oddity: The Bowie Bond*, WASHINGTON POST, Feb. 6, 1997, at C1.

<sup>130</sup> Sam Adler, "Bowie Bond Buyer Explains Investment", ENT. L. & FIN., Sept. 1997, 6.

<sup>131</sup> Duff & Phelps Credit Rating Co., *supra* note 99.

<sup>132</sup> Lewis, *supra* note 14.

notice to third party creditors of the security interest in these assets, Bowie filed a financing statement with the Secretary of State in the state where most of his business is conducted. However, since the assets being securitized included the copyrights and royalties deriving from these copyrights, Bowie did more than merely file a financing statement with the state in order to ensure that the security interest was perfected.

Although filing with the Secretary of State is sufficient to perfect a security interest in most assets, security interests in certain intangible assets that are subject to federal law, may not be perfected by simply filing with the state.<sup>133</sup> These intangible assets include copyrights, trademarks, and patent.<sup>134</sup> In cases where federal law preempts the area of law, and provides a mandatory registration system, a federal filing in the U.S. Copyright Office ("Copyright Office") will be required to perfect a security interest.<sup>135</sup> Thus, in order to perfect a security interest in an actual copyright, a federal filing is required.<sup>136</sup> However, some cases have held to perfect a security interest in royalty income deriving from a copyright, a U.C.C. filing is sufficient.<sup>137</sup> Because the law is unclear on this issue, the wise thing to do is to file both at the federal and state level in order to ensure that the interest will be found to be perfected. In the Bowie bonds deal, the perfection of the security interest in the royalties was therefore achieved by filing both with the Secretary of State and the Copyright Office.<sup>138</sup>

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<sup>133</sup> PETER H. WEIL, *ASSET-BACKED LENDING: A PRACTICAL GUIDE TO SECURED FINANCING*, 2-38, 2-39 (Practicing Law Institute 1996)..

<sup>134</sup> *Id.*

<sup>135</sup> *Id.*

<sup>136</sup> *In re Peregrine Entertainment, Ltd.*, 116 B.R. 194 (C.D. Cal. 1990) (stating that any state recordation system pertaining to an interest in a copyright is preempted by the Copyright Act, thus a creditor's security interest in the copyrights in films had to be recorded in the Copyright Office in order to be perfected).

<sup>137</sup> *See, e.g., Broadcast Music, Inc. v. Hirsh* 104 F.3d 1163 (9th Cir. 1997) (*Peregrine* distinguished from case involving outright assignment of royalty rights rather than a security interest in the copyright); *MCEG Sterling, Inc. v. Phillips Nizer Benjamin Krim & Ballon, et. al.*, 646 N.Y.S. 2d 778, (N.Y. Sup. Ct. 1996) (finding no malpractice where lawyer failed to perfect a security interest in a right to receive royalty payments by filing with the Copyright Office).

<sup>138</sup> Bencivenga, *supra* note 123.

The Bowie transaction also faced an additional copyright perfection hurdle that is not common in most asset-backed transactions. Many of Bowie's compositions were written before the 1976 Copyright Act became effective, so the 1909 Copyright Act applied.<sup>139</sup> Under section 24 of the 1909 Copyright Act, original works of authorship created prior to 1978 could be renewed by the author's heirs, who may not be bound by the securitization agreement.<sup>140</sup> Thus if Bowie were to die, his heirs could claim the copyrights and the royalties arising therefrom pursuant to section 24. This was obviously a concern of investors, and therefore releases from Bowie's heirs had to be obtained as well.<sup>141</sup>

### C. *Issuing of Music Royalty-Backed Securities*

As with any asset securitization, lawyers for the originator needed to issue a variety of opinion letters and other documentation to go forward with the deal. Bowie's lawyers complied with requests for opinion letters and other documentation from the investors' lawyers.<sup>142</sup> The opinion letters served as a safety net to ensure that there were no default in payments and that the SPV operates independently of the originator.

The Bowie Bonds were issued via a private offering. All of the securities were purchased by a single investor, Prudential Insurance Group ("Prudential"). Since the transaction did not involve a public offering, it did not have to be registered with the SEC pursuant to section 4(2) of the 1933 Act. Furthermore because Prudential is an "accredited investor" and a "qualified institutional buyer", the transaction would fall under both the Reg. D and Rule 144A exemptions to registration as well.<sup>143</sup>

To attract investors, the Bowie Bonds had to be rated by a reputable credit rating agency.

Moody's Investor's Services gave the Bowie Bonds a 3A rating,

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<sup>139</sup> *Id.*

<sup>140</sup> *Id.*; 17 U.S.C. 24 (1976)

<sup>141</sup> Bencivenga, *supra* note 123.

<sup>142</sup> Adler, *supra* note 95.

<sup>143</sup> Nicole Chu, *supra* note 1, at 488.



indicating that the bonds were of a high investment grade.<sup>144</sup> In addition, EMI Music provided an external credit enhancement on the bonds by guaranteeing to pay on the bonds if the revenues from the royalties dipped below a certain level. The credit enhancement that EMI provided to make Prudential feel secure in purchasing the bonds was a fifteen year licensing deal for the singer's back catalogue.<sup>145</sup> After fifteen years, the ownership of the master tapes revert back to Bowie.<sup>146,147</sup>

## V. BENEFITS AND COSTS OF MUSIC ROYALTY SECURITIZATION

### A. *Benefits*

Music royalty securitization provides better monetary rewards than either a bank loan or an advance, beats waiting around for the royalty checks to come in, and provides limited risk to an artist or songwriter that owns his musical catalogue ("owner"). While a bank loan requires personal guarantees, the money that an owner receives from music royalty securitization is non-recourse.<sup>148</sup> The investors suffer the risk if the royalties come in under expectation and even if the bond collapses, the owner only can lose ownership of the catalogue itself.<sup>149</sup> The investors have no rights to pursue the owner's other assets. Since owners like Bowie generally have many other valuable personal assets, the non-recourse nature of the securitization is a plus.

Asset-backed securities provide for longer-term financing.<sup>150</sup> For

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<sup>144</sup> Adler, *supra* note 95.

<sup>145</sup> *Id.* at 108.

<sup>146</sup> *Id.*

<sup>147</sup> The facts in the public record do not indicate whether or not Bowie is servicing the assets or not. One would assume that Bowie and his staff would be in the best position to the service the assets since they know best what royalties they are entitled to and how to go about collecting these royalties. Once these royalties are received Bowie would pass them on the SPV, who would then distribute them to the bondholders.

<sup>148</sup> Sam Adler, *David Bowie \$55 Million Haul; Using A Musician's Assets To Structure A Bond Offering*, Ent. L. & Fin., August 1997, at 1.

<sup>149</sup> Willcock, *supra* note 8.

<sup>150</sup> Erica Copulsky, *Can Ethan Penner Securitize Rock 'n' Roll?* INVESTMENT

instance, the Bowie Bond has a ten-year average life with a fifteen-year maturity. Bank loans to owners are relatively short-term, with a maximum of one to five years.<sup>151</sup> In addition, because banks prefer short-term liquidity, they lend less money up front. Banks will usually only lend up to 10% of the liquid assets of the borrower.<sup>152</sup> This is a fraction of what an owner can obtain through securitization.

Asset-backed securities are also indexed at a fixed rate for the life of the deal.<sup>153</sup> Bowie's interest rate was 7.9%. If interest rates were to rise, the fixed rate would not be affected. However, bank loans, by contrast are often indexed at a floating rate. Thus if the prime rate goes up to 20%, the owner would have to pay 20% plus the three or five points that the bank charges.<sup>154</sup>

There are also tax advantages to asset-securitization. Asset-backs are non-taxable.<sup>155</sup> The owner pays taxes over time as royalties are earned, and the coupon payment on the bond is tax deductible.<sup>156</sup> However, if Bowie had simply sold his catalogue for \$50 million, he would be taxed on the sale at about 50%. After taxes, Bowie would only receive \$25 million. Therefore, via the royalty securitization, the owner gets to defer the payment of taxes while enjoying the full \$50 million to invest today.

On this same matter, issuing bonds also offers the owner liquidity and diversity.<sup>157</sup> It yields immediate capital. Bowie can take the bond proceeds and place it in other investments paying a higher interest rate or even buy another catalogue.<sup>158</sup> Indeed, Bowie opted to purchase his manager's interest in some of his songs so that he could obtain all the copyright interests in his works.<sup>159</sup>

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DEALERS' DIGEST, Dec. 15, 1997, at 16.

<sup>151</sup> Adler, *supra* note 148.

<sup>152</sup> *Id.*

<sup>153</sup> *Id.*

<sup>154</sup> *Id.*

<sup>155</sup> *Id.*

<sup>156</sup> *Id.*

<sup>157</sup> Managing Intellectual Property, *supra* note 37.

<sup>158</sup> Simon Hamer, *Others Queue Up To Launch Asset Backs*, GLOBAL PRIVATE BANKING, April 14, 1997, at 12.

<sup>159</sup> Adler, *supra* note 148.

Another financial benefit of such a transaction is that an owner can do the transaction off of his balance sheet.<sup>160</sup> Since the record and publishing royalties are put in a SPV via a pre-sale transfer, the transaction would not appear as debt on the books as a bank loan would.

Lastly, and perhaps most important to owners, they can keep 100% of the copyrights and the rights that derive from them with these royalty-backed bonds.<sup>161</sup> Therefore, if the catalogue is worth twice as much after all the principal on the bond is paid off, the owner gets to keep all the future royalties.<sup>162</sup> Prior to securitization, the owner had to generally sell his or her copyrights to the record companies in order to obtain an advance and thus would be unable to reap future rewards. Moreover, the global marketplace and new technology creates increased opportunities for the value of copyrights to grow in the future.<sup>163</sup> Thus, financing that allows the owner to keep 100% of the copyright is highly desirable.

## B. *Costs*

The financial costs associated with a securitization can be extremely great due to the number of parties involved in the transaction and the variety of laws (securities, bankruptcy, copyright, corporate law, etc.) that the transaction has to be in compliance with. Each deal requires lengthy, time-consuming fact-specific analysis that results in huge documentation. This ultimately results in huge costs. The artists are responsible for the legal fees, the underwriting fees, rating agency fees, etc. Fees for the Bowie deal were around ten percent of the cost of the funds over the life of the bonds.<sup>164</sup> Some of these fees have to be paid up front.

Another cost of securitization is the loss of control of the assets. "You're dealing with third parties that have to make sure the loan gets liquidated. Clearly, you don't have the same freedom you would have

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<sup>160</sup> Hamer, *supra* note 158.

<sup>161</sup> Adler, *supra* note 148.

<sup>162</sup> Hamer, *supra* note 158.

<sup>163</sup> Adler, *supra* note 148.

<sup>164</sup> Willcock, *supra* note 8.

otherwise.”<sup>165</sup> For example, whereas before a owner could be extremely selective as to whom it licensed its works to, now with investors on its back for repayment, the owner may have to become less selective. This combined with the financial costs may not make a securitization a favorable option for some music industry participants.

However, the long-term benefit to the participants so outweigh the costs, that most owners would probably pursue a securitization if provided the opportunity.

## VI. BOWIE BONDS: BUST OR BOOM IN THE MUSIC INDUSTRY

Over the past two years, the Bowie Bonds have drawn a frenzy of attention from the white shoe-offices of investment banking firms to the artsy West Hollywood House of Blues night club.<sup>166</sup> Yet, despite the media hype, very few royalty securitizations have taken place since the Bowie Bonds were issued in 1997: Holland/Dozier/Holland, Ashford and Simpson, James Brown, Iron Maiden, and Rod Stewart.<sup>167</sup>

One must ask whether Bowie Bonds will really revolutionize the music industry as was once believed. The current state of the music industry suggests to me that while there may be interest, very few music industry participants will be able to go for the gold in the capital markets.

### A. *There is Only One Bowie And Very Few Can Be Like Him*

There are simply not enough David Bowies in the music industry for there to be a mass number of music royalty securitizations. One commentator stated, “David Bowie was tailor-made for securitization—he owned the rights to every song in his catalog of some 25 albums—but that is rare.”<sup>168</sup> I would have to agree. David Pullman, the creator of

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<sup>165</sup> Adler, *supra* note 96.

<sup>166</sup> See, e.g., David Osborne, *Entertainment: Money is the New Rock N' Roll As Stars Take Bowie's Lead*, THE INDEPENDENT, Oct. 1, 1997, 5; Adam Sandler, *Bonding with the Music Biz*, VARIETY, Oct. 6, 1997-Oct. 12, 1997, 32.

<sup>167</sup> Willcock, *supra* note 8; Alice Rawsthorn and Jeremy Grant, *Bonds Have More Fun As Banks Rock 'N Roll*, FIN. TIMES (London) Aug. 10, 1998, at 18.

<sup>168</sup> Andy Serwer, *A Sequel to the Bowie Bonds: Supreme Securities*, FORTUNE, June 8, 1998, at 313.

the Bowie Bond, even stated that “ownership of the publishing by the artist and to a certain extent record masters, is paramount for any deal to take place.”<sup>169</sup> Unfortunately, very few artists own the publishing rights or their record masters. Very few artists own a 25 record catalogue. Very few artists receive sole credit for their songs.<sup>170</sup> Quite simply, very few artists are like David Bowie.

### B. *Sampling And The Modern Musician*

The proliferation of digital sampling will also limit the number of music royalty securitizations that will occur in the future. Sampling is the process used by artists to include previously recorded portions of another artist into a new recording.<sup>171</sup> Digital sampling is embedded in nearly every hip-hop/rap song that we hear. Once thought to be only for rap/hip-hop music,<sup>172</sup> all one needs to do is turn on MTV to see how digital sampling has immersed itself into pop music as well.<sup>173</sup> Indeed, today “almost every pop record contains at least one sampled sound,” and many albums contain dozens.<sup>174</sup>

Among the many criticisms of sampling is the fact that it is having a negative impact on today’s musicians. One commentator suggests that the new “modern musician,” as exemplified by artists such as New Kids on the Block, Backstreet Boys, or N’Sync, lack the musical talent that older musicians possessed.<sup>175</sup> Many do not know how to play an

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<sup>169</sup> Nick Krewen, *Bowie’s Bondsman*, TORONTO STAR, Mar. 2, 1999.

<sup>170</sup> Nick Squires and Philip Finn, *Rock Stars Make Millions From A Sound Investment*, EVENING STANDARD, Mar. 19, 1997, at 14 (stating that the valuation of a Spice Girls Bond would be reduced because the band shares credits for their song with their producer).

<sup>171</sup> Kravis, *supra* note 92, at 232, 238.

<sup>172</sup> Micheal L. Baroni, *A Pirate’s Palette: The Dilemmas of Digital Sound Sampling And A Proposed Compulsory License Solution*, 11 U. Miami Ent. & Sports L. Rev. 65 (suggesting it was sampling that helped rap music develop as a musical form).

<sup>173</sup> See John Leland, *The Moper vs. the Rapper: A Lawsuit, Naturally*, NEWSWEEK, Jan. 6, 1992, at 55 (stating that sampling has become “common practice” in most rap and much pop.)

<sup>174</sup> Baroni, *supra* note 171, at 72.

<sup>175</sup> *Id.* At the time Baroni wrote his article, New Kids on the Block was the current pop fad. The equivalent of New Kids on the Block these days will probably

instrument, some can not sing, and most do not even write their own music.<sup>176</sup> Instead, these artists rely on “visual presentation” rather than musical talent to sell records.<sup>177</sup> Artists, such as Bowie, who can sing, perform, compose, and play an instrument, are becoming rare. While visual presentation does indeed sell records in the short-run, an artist that does not write or publish their own work at all will probably not have a long-standing, successful career in the music industry. As a result, the prospects for a securitization in the future for these modern musicians are quite bleak.

Digital sampling will impact on music royalty securitization in other ways as well. It is true that the original artists, whose works are sampled by upcoming rap and pop acts, will have a new stream of royalties at which to securitize. However, new artists utilizing these samples in their work will experience major difficulties if they pursue securitization themselves. First, many of these new musical styles are simply viewed as passing fads and not predictable enough to warrant securitization. Prudent investors will not want to sink money into a passing fad. Second, because these new artists pay royalties to the original artists for every work that they sample pursuant to the Copyright Act, their actual share of the royalties is quite limited, and may not be enough to obtain securitization.<sup>178</sup> Third, since securitization requires obtaining clear title to all potential royalty streams, the costs associated with determining who has title to the royalties in sampled works, may not justify a securitization.

### C. *The Music Business Is Tough*

The very nature of the music industry is also not conducive to the growth of securitization. First, very few people make it in the music

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be groups like the BackStreet Boys or N’ Sync.

<sup>176</sup> See, e.g., Geoff Boucher, *Hanson Travels A Rockier Road ‘This Time’*, LA Times, April 5, 2000, at F1 (stating “in 2000 youth pop is defined by slick harmonies and flashy choreography” and “the Backstreeters and N’Sync are called boy bands but they don’t play instruments and they rarely write their songs.”)

<sup>177</sup> *Id.*

<sup>178</sup> Omar L. Gallaga, *The Sound of Music Is Making Money*, AUSTIN AM. STATESMAN, Mar. 29, 1999, at D1.

business at all. For 99% of recording artists, 95% of their income is generated in the first six months of a release.<sup>179</sup> The first single can make or break an artist.<sup>180</sup> Very few can get pass the sophomore jinx, much less, a third or fourth album. Even less have a career spanning thirty years, with a consistent annual royalty flow of six figures.<sup>181</sup> Investors are not going to securitize the future royalties of an artist, songwriter, or publisher without having historical data that demonstrates a reliable and predictable stream.<sup>182</sup> Bowie, Brown, Ashford & Simpson, while maybe less popular now than the Spice Girls or Backstreet Boys, have the necessary track record needed for a securitization.<sup>183</sup>

#### D. *Who Needs It Anyway?*

Finally, there is also the problem that the individuals, who are most eligible for securitization are just not interested in securitization. The highest-earning stars (therefore the most attractive investment vehicles), are by definition, least likely to require additional capital.<sup>184</sup> However, unless stars have some overriding reason for cash in hand, the securitization process is probably not ideal for them.<sup>185</sup> Bowie needed it because he wanted to buy back his catalogue from his manager and address some estate planning concerns. Still other artists are worried about tarnishing their images by courting the financial markets.<sup>186</sup> This makes it impossible for a overwhelming number of securitization deals to take place.

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<sup>179</sup> Lynna Goch, *The Rocky (and Rolling) Road to Securitization*, BEST'S REVIEW-LIFE HEALTH INSUR. ED., Oct. 1, 1999, at 34.

<sup>180</sup> Bruce McCabe, *Are You Ready to Rock 'N Roll?* BOSTON GLOBE, July 25, 1999, at 3. (stating that the music business has become like the movie business: the first weekend makes or breaks a movie like the first single for a new artist).

<sup>181</sup> Krewen, *supra* note 168 (stating that a royalty stream of less that \$200,000 annually would not even justify the transaction cost associated with securitization).

<sup>182</sup> Willcock, *supra* note 8.

<sup>183</sup> *Id.*

<sup>184</sup> Rawthshorn and Grant, *supra* note 165.

<sup>185</sup> *Id.*

<sup>186</sup> *Id.*

## VII. CONCLUSION

The success of the Bowie Bonds has awakened a sleeping music industry to the financial rewards that can be achieved via asset securitization in the capital markets. As artists, songwriters and publishers clamor to become the next bond-winners, they must remember that there are unique aspects that made the Bowie securitization successful. Unless these individuals have a secure copyrightable interest in their royalties and a proven track record, Wall Street will never take them seriously. Unfortunately, as the music industry moves forward with digital sampling, there will be even fewer individuals who can even be considered for a music royalty securitization. Thus, while the pot of gold available to music industry participants in the capital markets is indeed sizeable, only few will be able to share in the wealth.



