Bowie Bonds: A Key to Unlocking, the Wealth of Intellectual Property

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Bowie Bonds: A Key to Unlocking, the Wealth of Intellectual Property

by

NICOLE CHU*

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Introduction

On January 31, 1997, David Bowie broke a new frontier in financing by selling $55 million in bonds backed by future music royalty payments and copyrights. Music royalties and copyrights had never previously been securitized due to the uncertainty in predicting future cash flows. David Bowie's bond offering represents a "brand new beat," a novel and innovative financing method for any individual or entity who owns intellectual property rights. The concept of intellectual property securitization resolves the dilemma of inexpensively raising a large amount of money, while still retaining ownership in the underlying intellectual property.

The concept of securitizing David Bowie's catalogue of recordings and song copyrights developed during a casual conversation between William L. Zysblat, Mr. Bowie's business manager, and investment banker David Pullman, a managing director at Fahnestock & Co. Mr. Zysblat mentioned that because Mr. Bowie's recording and distribution deal was about to expire, he was looking for possible financing vehicles. Mr. Bowie wanted to raise money for two primary reasons: 1) to buy out his former manager, who owned a minority of the rights to his music, and 2) to get a significant amount of cash up-front before returning to United Kingdom residency.

Mr. Pullman, known for securitizing exotic asset-backed securities (or as he calls them, "financial tech"), saw the immediate potential in Mr. Bowie's music catalogues - Mr. Bowie owned all of his music catalogues and rights dating back to the 1960's, cash flow was predictable with sales consistently over $1 million annually, there was no bad debt, and there was little risk involved. Richard Rudder, a partner

2. See id.
3. See Borrowers, Is this the biggest show in town?, EUROMONEY MAG., June 10, 1998, at 107 [hereinafter Borrowers]. Taxation on royalties in the United Kingdom, were they to go straight to Bowie, would be higher than that on the $55 million received in the United States from the securitization. See id.
5. See Bencivenga, supra note 1, at col. 2.
at Willkie, Farr & Gallagher, was brought in to handle all the legal aspects of the transaction.\(^6\)

The David Bowie securities ("Bowie bonds"), offer a 7.9% interest rate with a 10-year average life and a 15-year maturity.\(^7\) The bonds are backed by royalties on a twenty-five album catalogue consisting of about 300 songs of Bowie's recordings and song copyrights.\(^8\) EMI Music provided the credit enhancement necessary for the securitization, resulting in an A3 investment grade by Moody's Investors Service.\(^9\) The bonds were "snapped up" by Prudential Insurance in a traditional private placement.\(^10\) As a result of this deal, David Bowie has topped the charts as the richest British rock star with an estate worth an estimated $917 million.\(^11\)

Asset securitization of intellectual property touches upon copyright, bankruptcy, tax, and securities law, as well as being impacted by the Uniform Commercial Code. This securitization technique raises new possibilities for unlocking the wealth contained in intellectual property. The long-term acceptance of intellectual property securitization will impact artists and similarly situated people and companies. This note will provide a brief overview of the securitization structure, previous securitizations, the legal and policy areas involved in creating "Bowie-style bonds," and suggest future applications.

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7. See id. at 5. The 'average life' of a bond is the average weighted maturity based on an amortization schedule, or in other words, a calculation of how long it would take to earn half of the amount of the bond issue; the 'maturity' of a bond is the termination of the period that a note or other obligation has to run.


11. See Adler, David Bowie, supra note 6, at 1.

not only to other musicians, but also to other entities owning intellectual property rights.

I

Analysis

The full significance of the Bowie bond offering is best understood by first looking at the underlying financial structure, then the legal and policy areas involved, and finally the offering's importance for the future.

A. How Securitization Works

"Securitization" stands for the massive movement since the 1970's to transform illiquid debt into securities.13 Securitization opportunities exist for all types of assets that can either generate a stream of future income, or have the potential for generating a stream of future income.14 "The beauty of securitization is that you can be creative and structure solutions to meet different investor appetites."15 Prior to the Bowie bond deal, securitizations ranged from railway stock lease payments to earnings from exports such as liquor and international phone calls to government tax receipts.16

The basic structure of an asset-backed securitization is fairly simple. First, a company, known as the "Originator," must have a pool of quality receivables, or in other terms, income-producing assets.17 Examples of possible "income-producing assets" are credit card receivables, mortgage payments, and automobile loan payments.18 Second, the

15. Wong Wei Kong, Adapting securitization to needs of Singapore companies, BUS. TIMES (Sing.), July 27, 1998, at 19 (quoting Alex Lam, managing director of Singapore-based Asian Securitisation & Infrastructure Assurance (ASIA) Ltd.).
16. See Jeff Cossette, The Securitizers; Investors are lapping up everything from tequila to hurricanes to aging pop stars, INVESTOR REL., Oct. 1, 1997.
17. Peter F. Culver, The Dawning of Securitization, 8 PROB. & PROP. 34, 34 (1994).
Originator transfers these assets to a free-standing entity, known generally as the “special purpose vehicle” ("SPV"), specifically created for the transaction.\(^{19}\) The SPV is "special" because it is protected from any bankruptcy or insolvency proceedings of the Originator.\(^{20}\) The SPV can either be a corporation or a trust.\(^{21}\) Third, the SPV issues debt securities to investors which are backed by the assets transferred.\(^{22}\) Fourth, the proceeds from the sale of debt securities are used to pay the Originator for the transferred assets.\(^{23}\) Finally, the principal and interest payments on the debt securities issued by the SPV are paid out of the cash flow generated by the receivables.\(^{24}\)

The key to a successful securitization is the isolation of the assets from the Originator.\(^{25}\) Securitization requires a "true sale," which means that: 1) the SPV is an independent entity from the Originator; and 2) the investors must look only to the SPV for payment of income and principal on their securities.\(^{26}\) However, this isolation transfers both liquidity and credit risk to the investor.\(^{27}\) To make this type of investment attractive to the investors, credit enhancements, or supports, are typically used to protect against those risks.\(^{28}\) Credit enhancements come in many forms such as overcollateralization, third party guarantees, surety bonds, letters of credit and reserves.\(^{29}\) Thus, if there is an isolation of assets from the Originator and a corresponding credit enhancement, the securitization should be successful.

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19. See Culver, supra note 17, at 34.
20. See id. at 35.
21. See id. at 34.
22. See id.
23. See id.
25. See Culver, supra note 17, at 34.
26. See id.
27. See id.
28. See Shaw, supra note 24, at 251.
29. See id.
B. Application to Intellectual Property

In theory securitization of intellectual property is no different from typical securitizations involving credit card receivables, mortgages, and auto loans if a constant predictable cash flow exists. Intellectual property has previously been used as collateral to secure credit for start-up and financing ventures. For example, in 1995, Steven Spielberg, Jeffrey Katzenberg, and David Geffen founded Dreamworks, SKG. The one billion dollar loan used to fund the studio was arranged by Chemical Bank and secured largely by intellectual property holdings of the creators.30

However, the unpredictability of the cash flow and the difficulty in finding the necessary credit enhancement for intellectual property collateral greatly increases the risk associated with the financing method of securitization.31 The uncertainty stems from certain event risks, for example, if no one buys the income-producing assets for six months, or if there is a lawsuit, or if the company merges with another, etc.32 Due diligence33 is generally designed to cover these type of risks for mainstream asset-backed deals, but not for intellectual property asset-backed deals. If one can overcome both the uncertainty in cash flow and find the credit enhancement, the risk is reduced and you can apply the basic securitization structure.

Applying the basic securitization structure to "Bowie bonds," David Bowie's assets are a twenty-five album catalogue, roughly 300 songs, of Bowie's recordings and song copyrights.34 There are several revenue sources supporting the bonds. The two main sources are record royalties and

31. See Adler, supra note 6, at 7.
32. See Borrowers, supra note 3, at 107.
33. "Due diligence" is the process of investigation carried on usually by a disinterested third party on behalf of a party contemplating a business transaction for the purpose of providing information with which to evaluate the advantages and risks involved.
34. See Roberts, supra note 8, at 23.
publishing revenues. Since David Bowie actually owns his own record masters, all record royalties go to him. As for publishing revenues, there are mechanical royalties, synchronical usage (e.g. films, commercials), sheet music, air play, Muzak, voice mail, live performances and tours by Bowie. So there was a predictable cash flow with a measurable history dating back three decades. The credit enhancement was a third party guarantee given by EMI Music, which entered into a 15-year licensing deal for the singer's back catalogue. The licensing deal was the collateral put up for the investor, Prudential Insurance. After 15 years, ownership of the master tapes reverts back to David Bowie.

David Bowie assigned these assets over to a special purpose trust, another version of a SPV. Next, the trust issued debt securities backed by the assets, which were in turn purchased by Prudential Insurance in a private placement. The proceeds from the sale were transferred back to David Bowie. As the assets generate royalties, the royalties are used to service the debt.

The Bowie Bond deal is just a hint of the possible potential of the securitization of intellectual property rights. Applications can be envisioned beyond just entertainers, to novelists, screenwriters, playwrights, inventors, sports stars, music recording and publishing companies, and patents.

35. See id. Other sources include performances, video play, and air play. See Benclvenga, supra note 1, at col. 2.
36. See id.
37. See id.
38. See Adler, Interview, supra note 9, at 6.
39. See id.
40. See id.
41. See Alder, Bowie Breakthrough, supra note 10, at 5.
42. See Lisa Tibbitts, Rocker David Bowie May Securitize Earnings, 2 Asset-Backed Sec. Wk., Dec. 9, 1996, at 1, 11.
43. See id.
44. See id.
II
Comparisons to Previous Asset-Backed Securitizations

Examples of how the "typical" securitization operates in other contexts illustrate the novel issues created by the Bowie bonds.

A. Mortgages

The leader of securitization, historically and in terms of volume, has been the residential real estate mortgage market. In the 1970's, a secondary market was created largely through the efforts of the government, because the government wanted to increase the availability of funds for housing finance. Government National Mortgage Association, the Federal National Mortgage Association, and the Federal Home Loan Mortgage Corporation would purchase volumes of residential first mortgages, then combine them into large pools, then issue debt-securities to investors backed by the mortgages. The pool of quality receivables in this case are mortgages of residential properties. These "mortgage-backed securities" or "MBS" were the first securitizations. Securitizations were limited to fixed rate loans, where investors purchased "pass-through certificates", giving them a direct ownership interest in the pool of loans. "As the underlying loans were paid off, the investors received a share of the principal and interest payments made by the borrowers, and the mortgages served as collateral for the payments due to

45. See Culver, supra note 17, at 36.
47. See Culver, supra note 17, at 36.
48. See id.
49. Id.
50. "Pass-through certificates" are certificates representing an ownership interest in a pool of debt obligations from which payments of interest and principal pass from the debtor through an intermediary to the investor. See Marsha E. Simms, Asset Securitization, 754 Practicing Law Inst./Comm 335, 344 (1997).
51. See Culver, supra note 17, at 36.
investors. "52 "Today, the total amount of outstanding mortgage-backed securities is more than $1 trillion, making residential mortgage loans the most widely securitized financial asset."53

Comparing mortgage-backed securities to Bowie bonds, mortgage-backed securities are a tried and true asset securitization. The size of the residential mortgage securitization market alone indicates the successful nature of mortgage-backed securities. On the other hand, Bowie bonds are novel and although successful on an individual level, have not proven to be as easily applicable or adaptable to other individuals or entities. Although there is some uncertainty involved in the cash flow and maturity of a mortgage, a lot of the risk has been eliminated by virtue of three factors: 1) the development of uniform and simple underwriting criteria; 2) the use of standardized documentation; and 3) the development of broad and reliable historical data on default frequency and loss severity.54 Bowie-style bonds, in contrast, are private, research intensive, and involved a relatively small amount of money.

B. Rental Car Leases

One of the more common securitizations is that of rental car leases. A rental car company generally requires a great deal of money to service a large fleet of vehicles.55 Many companies turn to securitization versus a bank loan because the interest rate to pay back is lower.56 "Under the typical commercial paper structure, the rental car company issues a variable funding note ("VFN") to a special purpose entity ("SPE") which funds advances under the VFN by issuing commercial paper."57 In more familiar language, the VFN is the "income-producing asset" that supports the commercial paper

52. Id.
53. Id.
54. See id. at 37.
56. See id.
57. Id.
or "security" and allows the SPE to fund the advances or "sale." The credit enhancement used to reduce the risk to the investor is generally a combination of a liquid facility and a letter of credit. If properly structured, the commercial paper qualifies for a rating of 'A-1' by Standard & Poor's Ratings Group and 'P-1' by Moody's Investor Services, Inc. The commercial paper is serviced by payments from the VFN, which consist of payments made under the motor vehicle lease agreement and proceeds generated from the sales of vehicles under manufacturers' repurchase programs or at auction.

In comparison to the Bowie bonds, the rental car lease securitizations are very generic. Rental car lease payments and sale proceeds are fairly predictable with a measurable history, unlike the Bowie bonds where the cash flow from Bowie's music royalties is indeterminate. "There's no limit on the downside or the upside so its harder to analyze what's going to happen going forward." Additionally, with rental car leases, there's no question who owns the underlying assets. Although the Bowie bonds were a special case because Bowie owned all the copyrights, generally there is a complex title chain that needs to be sorted out.

C. Film Financing

A securitization closer in subject matter to the Bowie bonds is structured film financing. Film studios also need large amounts of money to produce future films and have looked to securitization as a financing vehicle.

An example of film financing could be where the studio/distributor, known as the "transferor," transfers the film rights of specified motion pictures that were produced or acquired by the Transferor during a specified period of time.

58. "To obtain the desired credit rating, the commercial paper must usually be supported by a 364-day revolving liquidity facility provided to the SPE by domestic and foreign commercial banks which have short-term unsecured credit ratings of at least 'A-1' by Standard & Poor's and 'P-1' by Moody's." Id.
59. See id.
60. Id.
61. See id.
62. Adler, David Bowie, supra note 6, at 7 (quoting Richard Rudder).
BOWIE BONDS

("the income-producing assets") to a special purpose company ("SPC"), which is owned by independent equity holders. To secure the financing by the SPC, the Transferor grants film rights, rights to payments, and the gross receipts. So as the film(s) generate revenues, the principal and interest payments on the debt securities are serviced.

Both structured film financing and Bowie bonds involve intellectual property-type securitizations. However, in the case of film financing, there are more income-producing assets of greater volume, such as distribution rights, commercial tie-in rights, merchandising rights, and soundtrack rights. The Bowie bonds, however, consist solely of David Bowie's music royalties and copyrights as the pool of income-producing assets. Additionally, although the film studios cash flow are somewhat unpredictable, the fact that they are generally corporate entities with several films to market and earn revenues on, reduces the overall risk. The Bowie bonds are offered by a single individual, which typically, although not in this particular case, is more risky.

III
Legal Concerns

Securitization involves many different legal areas. This note will give a brief but not comprehensive overview of the main legal areas involved in a Bowie bond-type securitization.


The primary area of law introduced into securitizations by the Bowie bond-type offering, is intellectual property. More specifically, the areas of copyright, trademark, and patents are implicated. Historically, intellectual property has been used as collateral for secured credit in start-up and financing ventures. For example, Westinghouse Corporation financed

63. Reade H. Ryan, Jr., Structured Film Financing, 759 Practicing Law Inst./Comm 509, 521 (1997). The Transferor must offer to the SPC all motion pictures produced or acquired during the specified time, regardless of eligibility to prevent any "cherry-picking" of the motion pictures. See id. at 523.
64. See id. at 533.
65. See Ghosh, supra note 30, at 103.
its $10 billion bid for CBS through a loan secured by Westinghouse's intellectual property rights.\textsuperscript{66}

Intellectual property laws promote and protect two conflicting interests: 1) the stimulation of creativity; and 2) the exclusion by the creators of others from using the product of such creative efforts.\textsuperscript{67} The primary statutes are the Copyright Act of 1976, the Lanham Act of 1946, and the Patent Act. Copyright protects "original works of authorship" and gives the author the right to exclude others from using, copying, or compiling the work.\textsuperscript{68} The exclusive economic rights of a copyright can be broken down into five main types: 1) reproduction; 2) adaption; 3) distribution; 4) public performance; and 5) public display.\textsuperscript{69} Trademark protects the trademark holder's right to use a mark to designate origin and signal quality on products traded through interstate commerce.\textsuperscript{70} Patent protection gives the owner a monopoly of an invention for a limited term if the invention is non-obvious, novel & useful.\textsuperscript{71}

Using intellectual property as the "income-producing asset" is the innovative aspect of securitization that uniquely distinguishes Bowie bonds. Most of the problems that arise in using intellectual property as an incoming-producing asset can be attributed to the unpredictability of cash flows and/or revenue sources. Generally the types of assets most suitable for securitization are those with standardized terms, delinquency and loss experience that can support an actuarial analysis of expected losses, and uniform underwriting standards and servicing procedures satisfactory to rating agencies and investors.\textsuperscript{72}

The problem in using intellectual property as the base for securitization is estimating cash flows from some of the

\textsuperscript{66} See id.
\textsuperscript{67} See id. at 111.
\textsuperscript{69} 17 U.S.C. § 106 (West 1998).
economic rights of a copyright or the profitability of a trademark or patent. Not only are the cash flows very nebulous, but the analyses are heavily research-intensive. Such irregularities present a higher risk and a greater need for credit enhancement to create a more attractive deal. Thus, until the Bowie bond deal, securitization of intellectual property was overlooked.

The Bowie bonds were a securitization of music royalties and copyrights. David Bowie's works are considered musical works and sound recordings under the Copyright Act of 1976 §§ 101 and 102. He registered all his copyrights at the United States Copyright Office, which protects them in countries that have adopted a copyright convention. He holds the exclusive rights of reproduction, production of derivative works, distribution, and display.

Although not utilized in the Bowie bond offering, a securitization of intellectual property could be structured by use of bundling, or packaging of certain rights. For instance, one could bundle the rights of reproduction and distribution together as the pool of income-producing assets, and securitize those. Or one could bundle the copyright for a product and the trademark for a product. As long as one can identify a discrete pool of assets, carve them off, restructure the credit profile into different investor classes, and sell the resulting securities to the appropriate entities, securitization should be possible.\(^7\)

\section{B. Bankruptcy Law}

Next, one must consider the application of the bankruptcy laws. The principal bankruptcy law issues involved in securitization relate to the isolation of the assets from the credit risk of the Seller/Originator.\(^7\) In other words, when the Seller is subject to the Bankruptcy Code, it will be necessary to structure the transaction so that the assets will not be

\begin{footnotes}
\begin{enumerate}
\item[73.] See 17 U.S.C. § 411.
\item[74.] See Cossette, \textit{supra} note 16.
\item[75.] See Shaw, \textit{supra} note 24, at 252.
\end{enumerate}
\end{footnotes}
included in the bankruptcy estate of the Seller if the Seller becomes insolvent.\textsuperscript{76}

The major effects of bankruptcy on securitization and security holders are: 1) an automatic stay on the creditors' actions;\textsuperscript{77} 2) a prohibition on preferences among creditors;\textsuperscript{78} 3) the power of the trustee in bankruptcy to avoid certain transactions;\textsuperscript{79} 4) the power of the court to subordinate creditors' claims to those of others;\textsuperscript{80} and 5) the right of the debtor and some of his creditors to setoff their mutual claims.\textsuperscript{81}

The three main reasons for including the assets in the Seller's bankruptcy estate are: 1) if the transfer was a secured loan and not a true sale; 2) if in the interests of equity there should be a substantive consolidation; and 3) if there was a fraudulent conveyance.\textsuperscript{82} The transfer to a SPV can either be characterized as a sale of the assets, or as a secured loan backed by the transferred assets.\textsuperscript{83} If the transfer is considered a "true sale," then the assets are isolated from the Originator's bankruptcy estate, and the SPV is bankruptcy-remote.\textsuperscript{84} If the transfer is considered a loan instead of a sale, then the assets are considered property of the bankruptcy estate and subject to various provisions of the Bankruptcy Code.\textsuperscript{85}

When determining whether a transaction will be treated as a sale or loan, state law controls.\textsuperscript{86} One of the main considerations is the intent of the parties. Although the parties cannot transform a loan into a sale merely by calling the transaction a sale,\textsuperscript{87} the form of a transaction is a factor in

\textsuperscript{76} See id.
\textsuperscript{77} See Bankruptcy Code § 362(a), 11 U.S.C. § 362(a) (West 1998).
\textsuperscript{78} See Bankruptcy Code § 547.
\textsuperscript{79} See Bankruptcy Code §§ 544, 545, 547, 548, 553.
\textsuperscript{80} See Bankruptcy Code § 510.
\textsuperscript{81} See Bankruptcy Code § 553; FRANKEL, supra note 13, at 405.
\textsuperscript{82} See Shaw, supra note 24, at 253-55.
\textsuperscript{83} See Simms, supra note 50, at 344.
\textsuperscript{84} See Bankruptcy Code § 541(d).
\textsuperscript{85} See Bankruptcy Code §§ 361, 362, 363, 364, and 541.
\textsuperscript{87} See Major's Furniture Mart, Inc. v. Castle Credit Corp., Inc., 602 F.2d 538 (3d Cir. 1979).
the court's consideration. Other factors that may affect the characterization of the transfer of the receivables are: 1) the Issuer's direct or indirect recourse against the Seller in the event of nonpayment by the obligor of the underlying receivables; 2) the Seller's right to manage the receivables underlying the securities and control the payments received; 3) the extent to which Seller has retained the economic benefits of the receivables through a right to repurchase the underlying obligations; and 4) the accounting and tax treatment of the transaction.

Substantive consolidation is the theory permitting a court to disregard the separateness of the entities and to consolidate and pool the entities' assets and liabilities together. In general, substantive consolidation may result if creditors of the bankrupt entity reasonably dealt with both entities as a single unit and creditors of the non-bankrupt entity did not reasonably rely on its separate identity. It may also result if the business or operations of the entities are so intermingled as to make separation impractical.

Finally, fraudulent conveyance is where the conveyance of property is made for the purpose of rendering the property unavailable for satisfaction of a debt or otherwise hindering or defeating the rights of creditors. Fraudulent conveyance can either be "actual" or "constructive." Actual fraud is where a transfer was made with actual intent to hinder, delay or defraud any entity to which the debtor was indebted. Constructive fraud is where a trustee in bankruptcy may recover any amount transferred for less than a "reasonably equivalent value" if the debtor was insolvent or rendered insolvent at the time of transfer.

89. See Shaw, supra note 24, at 253-55.
90. See Simms, supra note 50, at 350.
91. See Shaw, supra note 24, at 255.
92. See id.
94. See id.
Bowie bonds were structured as a "true sale" and thus not subject to bankruptcy issues.

C. Uniform Commercial Code ("U.C.C.")

The Uniform Commercial Code works in conjunction with the bankruptcy laws. In an asset-backed securitization, one must determine whether a transfer of assets from the Originator to the SPV has occurred and what rights the SPV has against the obligors on the assets being transferred.95 If the transfer is recharacterized as a loan, instead of a true sale, then the SPV should also have a perfected security interest in the assets being transferred.96

Article 9 of the U.C.C applies to "any transaction which is intended to create a security interest in personal property or fixtures including goods, documents, instruments, general intangibles, chattel paper or accounts, and also to any sale of accounts or chattel paper."97 To perfect a security interest, the security interest must attach and one of the following must occur: 1) filing of a financing statement,98 2) taking possession,99 or 3) automatic perfection.100 A security interest attaches when: 1) the collateral is in the possession of the secured party or the debtor has signed a security agreement describing the collateral; 2) value has been given; and 3) the debtor has rights in the collateral.101 The two main consequences of attachment are that the security interest becomes enforceable against the debtor and with perfection, third parties.102

95. See Simms, supra note 50, at 373.
96. See id. "Perfection" is the process that parties must go through to make sure that the creditor's security interest in the collateral is good against most of the rest of the world (i.e., debtor's bankruptcy or other creditors). See U.C.C. §§ 9-203, 9-303, 9-305, 9-402(1) (1991).
97. U.C.C. §9-102(1).
98. See U.C.C. §9-402(1). Exceptions to filing are largely contained in U.C.C. § 9-302.
99. See U.C.C. §9-305.
100. See U.C.C. §9-303; Simms, supra note 50, at 375.
101. See U.C.C. §9-203.
102. See Simms, supra note 50, at 375.
Once attached, the security interest can be perfected by either filing a financing statement against the debtor in the state of the debtor’s principal place of business, or possession of certain kinds of collateral, or automatic perfection. Perfection is required by rating agencies and underwriters in securitizations to give a secured creditor protection against third parties.

The securitization of the Bowie bonds was structured as a true sale and, as a precaution, a perfected loan. The attachment occurred when copyrights were given to a secured party (the trust), value was assigned at $55 million, and Bowie owned the underlying copyrights. Perfection occurred when a financing statement was filed with the Copyright Office.

D. Tax Law

One of the main advantages with intellectual property securitizations is taxes. The person or entity that sells the assets/receivables to the SPV is essentially borrowing money and paying it back through future royalties. The controlling issue with respect to recognition of gain or loss is whether the transfer itself is viewed as a taxable sale of the receivables or, instead, as a loan secured by the receivables. Only in the case of a taxable sale does the transfer result in a taxable event. So although the Bowie bond offering was a “true sale” for bankruptcy purposes, the financing was structured as a loan for tax purposes. The loan, which is the cash up front, is free of income tax.

The tax law applicable to the SPV concerns “pay-through notes.” Pay-through notes are debt obligations of a legal entity

104. See U.C.C. §§ 9-401, 9-402.
105. See U.C.C. § 9-305.
109. See Schneider, supra note 14, at 204.
110. See id.
that is collateralized by the receivables or the income-producing assets. The SPV, or issuer, is still considered to be the owner of the underlying receivables, the SPV is still responsible for the income earned on the receivables. The SPV in a pay-through transaction will not qualify as a nontaxable grantor trust because the SPV is obligated to actively manage cash flows to ensure that its debt securities will be paid at their scheduled maturities. To avoid separate or entity-level taxation of the SPV, the SPV is generally structured as either a single-purpose subsidiary of the originator or as a partnership.

Finally, the third area of taxation relates to the investors. Investors will be taxed like any other holders of debt, interest paid on securities will be treated as ordinary income, and payment of principal is generally nontaxable. In other words, principal payments with respect to receivables are treated as a non-taxable return of basis and all items of interest with respect to receivables must be treated as ordinary income.

In the case of Bowie bonds, Bowie is the originator who transferred the copyrights to a special purpose trust. Since the bond offering was structured as a financing, or a loan instead of a sale for tax purposes, the transfer was a non-taxable event. However, Bowie will still have to pay taxes on the royalties earned. The SPV was structured as a trust, avoiding separate entity-level taxation, which then issued debt securities that were sold to Prudential Insurance. Prudential Insurance will have to pay taxes on the interest earned on the securities, but not on the return of principal.

Other tax considerations are the fact that Bowie as an individual is sponsoring the deal instead of a corporation or a financial institution, and that Bowie is a non-resident of the

112. See Simms, supra note 50, at 359.
113. See id. at 360.
114. See Schneider, supra note 14, at 214.
115. See id. at 215.
116. See id. at 220.
117. See I.R.C. § 61.
118. See I.R.C. § 108.
United States, which increases the riskiness and complexity involved in securitization.¹¹⁹

E. Securities Law

Finally, the last major consideration is registration with the Securities and Exchange Commission ("SEC"). There are three main statutory provisions that apply to asset-backed securitizations. First, there is the registration requirement under section 5 of the Securities Act of 1933 which governs offers to sell and the actual sale of securities through the facilities of interstate commerce.¹²⁰ Section 5 states that "[u]nless a registration statement is in effect as to a security, it shall be unlawful for any person . . . (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use of a medium of any prospectus or otherwise . . . ."¹²¹

Second, one must look to see if there is an applicable exemption for registration under section 4. For private placements, section 4(2) exempts transactions by an issuer "not involving any public offering."¹²² Regulation D, promulgated by the SEC, provides a safe harbor for these transfers.¹²³ Additionally, Rule 144A under the 1933 Act excepts certain secondary market transactions from the registration requirements of the 1933 Act.¹²⁴

Third, one then applies Rule 144A to any subsequent transfers. Rule 144A exempts certain secondary market transactions in privately-placed securities from the registration requirements of the 1933 Act.¹²⁵ For Rule 144A to apply, the transaction must be to a qualified institutional buyer, the buyer must be aware that the exemption is being

¹¹⁹ See Adler, Bowie Breakthrough, supra note 10, at 7.
¹²¹ Securities Act of 1933 § 5.
¹²² Securities Act of 1933 § 4(2).
¹²⁴ See 17 C.F.R. § 230.144A; Simms, supra note 50, at 367.
¹²⁵ See Simms, supra note 50, at 368.
used, and the issued securities must be different from any other securities listed on a national exchange or quotation system.\textsuperscript{126}

The Bowie bonds qualified for the section 4(2) exemption of a private offering. Thus both Regulation D and Rule 144A apply. The qualified institutional buyer in this transaction is Prudential Insurance, who was aware of the use of the exemption, and the Bowie bonds are obviously different from any other security.

\textbf{IV}  
\textbf{Policy Concerns}  

Many policy concerns are raised by the Bowie bond offering ranging from the micro-level of individual ramifications to the macro-level future ramifications of using securitization as a major financing vehicle for intellectual property.

\textbf{A. Effect on Artists or Similarly Situated People or Companies}  

There are a number of benefits to securitization for the musician, or artist, or any other entity that has assets which create a predictable cash flow. First, the "entity" can obtain a large amount of cash up-front to invest or spend otherwise, that it could not obtain from an advance or a personal loan.\textsuperscript{127} Other advantages of securitization over personal loans include: 1) the cash from a securitization is non-recourse, unlike bank loans which require a personal guarantee;\textsuperscript{128} 2) the interest is fixed, unlike bank loans which are indexed to a floating rate;\textsuperscript{129} 3) the asset-backed securities are long-term deals, unlike the one to five year deals allowed by bank loans;\textsuperscript{130} and 4) they are non-taxable events to the Originator, unlike bank loans.\textsuperscript{131}

\begin{itemize}
\item \textsuperscript{126} See id.
\item \textsuperscript{127} See Roberts, supra note 8, at 23.
\item \textsuperscript{128} See Adler, \textit{David Bowie}, supra note 6, at 1.
\item \textsuperscript{129} See id.
\item \textsuperscript{130} See id. at 5.
\item \textsuperscript{131} See id.
\end{itemize}
Second, the entity is entitled to keep 100% ownership of the underlying intellectual property assets. Previously, the “artist had no choice but to sell his or her copyrights to the Big Six record companies ... [but now] independent record and publishing companies [can] stay independent ....” Additionally, if the royalties are greater than expected, the bonds get retired early. Or if the interest rates rise or the entity invests the cash in something with a higher rate of return, the individual or entity comes out ahead.

Third, the bonds can give the heirs of the intellectual property owner the cash they need to cover estate taxes without having to sell the underlying assets. In addition, if the assets are transferred to the “heirs” while the individual is still living, the “heirs” have ready cash to use for their own needs as well as for taking care of their benefactor. Also, any appreciation on the bond is not taxed when passed to the heirs.

Finally, there are lower administration costs charged to the entity. The publishing houses typically charge a high administrative cost because they are giving money up-front and they keep all the black box income (i.e., excess international royalties), which can add up to about a 20% interest rate. But, “[i]n a structured-asset situation, the artist gets all the black box income, thus ‘picking up a minimum of about 20 percent additional annual income because ... he is [now] indirectly administrating,’ ... [and the investment banker’s cost] works out to just under 10 percent.”

132. See id.
133. Id.
134. See Kadlec, supra note 108, at 39.
135. See David Lieberman, Singing praises of bond issues Pop music latest investment trend, USA TODAY, April 21, 1998, at 08B.
136. See Adler, David Bowie, supra note 6, at 5.
137. See id.
138. See id.
139. See id.
140. See id. at 5-6.
141. Id. at 6.
However, there is a downside to securitization for any "entity," primarily in the area of control. "With any financing, you lose some control over your 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 otherwise." There is also the issue of having a pool of quality receivables or income-producing assets large enough to produce or generate a steady and predictable cash flow for securitization. One possible solution to creating a bigger and more reliable cash flow is to pool a diversified group of loans together, which is not dependent on one pool of intellectual property assets. Additionally, another obstacle to securitization is the number of built-in costs, such as rating agency fees, underwriting, structuring and trust fees, and premiums for third party guarantors.

The bottom line is, if one can structure the securitization correctly to minimize the loss of control and the costs, the upside of the bond offering more than compensates the Originator for the securitization.

**B. Reactions of the Music Industry, the Investment Banking Industry, and Other Potential Industries**

Overall, the music industry has shown a lot of interest in the Bowie bond deal. Several artists, mostly British, have indicated interest in structuring their own bond offerings. One reason is that there are many venerable British rock bands whose music still sells in large quantities. Another reason is that British musicians seem to have more control over their business affairs than American musicians. Nomura Capital Entertainment recently arranged a $15.4

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144. *See* id. (For example, one could create a pool of loans consisting of loans to rock stars, actors, and individual studio executives.)
147. *See* id.
148. *See* id.
million loan for Rod Stewart that was secured by the star's future royalties.\textsuperscript{149} Another current "deal" known to be in the works is the American group of Crosby, Stills, and Nash, the folk and rock group that had a string of hits in the late 1960's and 1970's.\textsuperscript{150} But as Bill Zysblat aptly comments on all the interest generated, "[t]he Bowie deal was a blessing and a curse... it was successful, but it created high expectations."\textsuperscript{151}

Record companies have also shown more than casual interest in Bowie bonds.\textsuperscript{152} This interest is due to the fact that most record companies own the "lion's share of assets."\textsuperscript{153} The company can use the assets as collateral or sell the assets to raise capital, and it would not appear as debt on their balance sheet.\textsuperscript{154} Asset-backed financing "might be attractive to a bigger company at some point as a way to dress up an annual report."\textsuperscript{155}

Before the market can really grow, however, investment banks have to learn to efficiently structure similar-type deals, and investors need to feel comfortable about buying them.\textsuperscript{156} Right now, each potential "deal" requires a lengthy, time-consuming, fact-specific analysis leading to huge documentation.\textsuperscript{157} Also, due to the nature of the deal, the financial information stays for the most part, confidential and private.\textsuperscript{158} But most financial institutions have indicated an interest in getting involved in the intellectual property area.\textsuperscript{159}

\textsuperscript{149} See Kadlec, supra note 108, at 39.
\textsuperscript{151} Andy Serwer, \textit{A Sequel to Bowie Bonds: Supreme Securities}, FORTUNE, June 8, 1998, at 313 (explaining further, David Bowie was tailor-made for securitization, he owned the rights to every song in his catalog of some twenty-five albums).
\textsuperscript{152} See Adler, \textit{Bowie Breakthrough}, supra note 10, at 7.
\textsuperscript{153} See id.
\textsuperscript{154} See id.
\textsuperscript{155} Id. (quoting Richard Rudder).
\textsuperscript{156} See Copulsky, supra note 143, at 16.
\textsuperscript{157} See id.
\textsuperscript{158} See Catherine Siskos, \textit{How to Own a Piece of a Rockstar}, 52 KIPLINGER'S PERS. FIN. MAG., July 1, 1998, at 18.
\textsuperscript{159} See Barbara Wall, \textit{Seeing Stardust Securities in Entertainment Income Q & A / Charles Koppelman, CAK Universal Credit Corp.}, INT'L HERALD TRIB., June 6,
In the investment banking industry, the larger commercial banks are starting to become interested in developing similar asset-backed securitization deals of their own.160 Some of these deals have already been done in Latin America and Asia.161 David Pullman, who structured the Bowie deal, is not too worried about the competition because the Bowie deal was sold privately, the research-intensiveness of this type of deal may be prohibiting to many potential entrants into the field, and the amount of money involved is typically smaller and less lucrative than credit card or auto loans receivables.162 But, Pullman suggests that if the investment banks expand the Bowie bond-type deal to other industries, there might be enough “big money” to make it worthwhile.163

Other potential industries include that of high-tech and bio-tech. Here, the industrial response has been lukewarm. Some commentators think that intellectual property should not be treated as an economic good.164 They believe that intellectual property should only be sold when embedded in an actual product.165 Other commentators have remarked that the normal avenues of financing should be tried first.166 For example, an artist could take out a personal loan and repay it with the royalties he/she earns.167 In the end, most commentators conclude that the development and utilization

1998, at 18.
160. See Elstein, supra note 4, at 20. As of now, the major players are: The Pullman Group (David Pullman is the managing director); Capital Company of America Entertainment Finance (Nomura Securities is the entertainment finance group run by Ethan Penner); Société Generale (French bank’s film financing arm run by Premila Hoon, media and entertainment arm headed by Avi Oster); Merrill Lynch (Dorien Klein); Bear Stearns (Lesley Goldwasser); Citibank; CAK Universal Credit Corporation (joint venture between Prudential Securities, Robert D’Loren and Charles A. Koppelman); Prudential Investments-RZO (joint venture). See also Borrowers, supra note 3, at 107.
161. See Elstein, supra note 4, at 20.
163. See id.
165. See id.
166. See id.
167. See Roberts, supra note 8, at 23.
of new financing techniques is necessary to take advantage of the rich intellectual property base.\footnote{168}{See Haber, supra note 164, at 93.}

\section*{C. The Advantages and Disadvantages to Investors or Bondholders}

Although there will always be risk-taking investors who are looking for the "newest thing" in investing and would snap up bonds such as the Bowie bonds, the general public is understandably more cautious towards them.\footnote{169}{See \textit{Bowie Ch-Ch-Ch-Ch-Changes the Face of the Bond Market}, LUCE press clippings, \textit{BLOOMBERG NEWS}, Feb. 9, 1997.} One author states, "[p]lenty of investors . . . found the bond too outlandish and the interest rate too low to compensate for the risks involved in investing in an artist many consider to be past his prime."\footnote{170}{Id.} Additionally, the investor bears the risk if royalties come in lower than expected, as well as the risk of a bond that does not trade actively and should be held until maturity.\footnote{171}{See \textit{Kadlec}, supra note 108, at 39.}

Despite the risks involved, investors have the assurance that the royalties are set at a certain rate that cannot be lowered, the songs backing the Bowie bonds have a long track record for generating royalties, and the transaction was perfected. Another advantage is that investors might like to diversify beyond the typical credit cards receivables and auto loans.\footnote{172}{See \textit{Elstein}, supra note 4, at 20.} Increasing investor appetite, however, is most likely to occur if intellectual property securitization deals can be done without the need for a guarantee, rendering a higher promised return to investors and a perceived security that investors will be repaid.\footnote{173}{See \textit{Copulsky}, supra note 143, at 16.}

\section*{D. Securitization as a Major Financing Vehicle for Intellectual Property}

The asset-backed securities market has grown exponentially in the last few decades.\footnote{174}{See id.} In 1996 alone, the
The asset-backed securities market was $200 billion. However, according to a March 1997 report from Arthur Andersen, the total volume of securities backed by intellectual property assets issued since 1991 was a mere $1.6 billion, with many of these securities being backed by tangible assets as well. As a financing vehicle, asset-backed securities have been compared to the junk bonds of the 1980's since both serve as a source of funding for companies which could not otherwise get funding. In the vast intellectual property market which includes record masters, publishing, syndication, television, film libraries, high tech licenses and biotech licenses and where production or research costs are high, a new funding source is desirable.

1. Completed or Pending Deals

The most obvious application of the Bowie bond securitization is to other musical offerings. The music of rock legends like the Rolling Stones or the Beatles, or even the classical music catalogues of Gershwin or Berlin, would be prime choices. In fact, in July of 1998, David Pullman completed his second bond offering and raised $30 million for the Motown writing trio of Edward and Brian Hooland and Lamont Dozier, whose assets have been valued at over $100 million. Pullman structured the Motown deal based only on publishing rights, and again it was sold as a private placement. Unlike the Bowie Bond deal, the Motown deal is based purely on the assets without a guarantee. As mentioned in the previous section, the Motown bond offering is actually a better example of how an intellectual property...

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175. See Borrowers, supra note 3, at 107.
176. See id.
177. See Elstein, supra note 4, at 20.
179. See Haber, supra note 164, at 93.
180. See Elstein, supra note 4, at 20.
181. See Borrowers, supra note 3, at 107. The writing trio's songs include the hits, Stop! in the Name of Love, Baby I Need Your Loving, and How Sweet It Is To Be Loved By You. See id.
182. See id.
183. See id.
securitization should or could be done without some form of a guarantee or credit enhancement.

Taking it one step further to copyrights in other fields such as literary estates, television, or film studios, one could securitize the earnings of best-selling authors like Stephen King\(^{184}\) or John Steinbeck,\(^{185}\) or writers for television favorites like "Seinfeld,"\(^{186}\) or film studios like Dreamworks.

As stated above, many film studios need large amounts of money for movie productions.\(^{187}\) There are basically two ways of doing film securitizations: either use the future receivables from a film yet to be released or draw on the income from a film library.\(^{188}\) Last November, Bear Stearns raised securitized debt backed by 10 films yet to be made for Dreamworks.\(^{189}\) Merrill Lynch underwrote a $265 million floating rate note for Italian film company Cecchi Gori, mostly backed by a library of films; the rest to be taken from 145 films yet to be released.\(^{190}\) Société Generale underwrote a $350 million deal for New Line Cinema, backed by various international and U.S. film receivables.\(^{191}\) Finally, Citibank was involved in a $650 million deal for Polygram.\(^{192}\) At least in the context of film financing, Bowie-style securitizations have definitely been utilized.

Going even farther afield, it has been suggested that Bowie bond securitization could be applied to sports stars, sports teams, and related services. SPP Hambro is close to cutting a deal for a $20 million sale of nine-year securities for Major League Baseball slugger Frank Thomas\(^{193}\) of the Chicago White Sox backed by future salary payments.\(^{194}\) There are several

\(^{184}\) See Bencivenga, supra note 1, at col. 2.

\(^{185}\) See Borrowers, supra note 3, at 107.

\(^{186}\) See id.

\(^{187}\) See supra Part II.B.

\(^{188}\) See Borrowers, supra note 3, at 107.

\(^{189}\) See id.

\(^{190}\) See id.

\(^{191}\) See id.

\(^{192}\) See id.

\(^{193}\) See Dan Weil, A Hit or a Miss? Bonds Based on Athlete's Earning Power can be Risky, AUSTIN AMERICAN-STATESMAN, Aug. 14, 1998, at D1.

\(^{194}\) See id.
risks to athlete bonds, such as contract clauses for immoral behavior, a career-ending injury, a strike, or the possibility of diminishing revenue. However, these risks can be protected against for the most part, by purchasing insurance.\textsuperscript{195} The incentive in creating a new class of athlete bonds, for those who actually need the money, is to receive a large lump of untaxed money to invest immediately rather than a salary over many years.\textsuperscript{196}

The English soccer team, \textit{Newcastle United}, is considering whether to offer securities backed by prospective ticket and merchandise sales to its loyal fans.\textsuperscript{197} Rapidly escalating soccer-player salaries have created a need for large amounts of money up-front.\textsuperscript{198} The most likely scenario for securitization by a sports team candidate is "when a sports team is sold and [there is] new ownership, with new credit lines, [and the team] securitizes assets to help finance the acquisition."\textsuperscript{199}

In terms of sport services, owners could securitize the ticket receivables, skybox revenues, broadcasting rights, concession sales, program sales, or even the salaries of the best-paid sports stars.\textsuperscript{200} In connection with the sports teams, state and local governments that are spending massive amounts of money to build new ballparks and arenas could securitize their share of the stadium earnings. The earnings could then cover expenses for stadium construction.\textsuperscript{201}

All the completed and pending deals have run into many difficulties, which explains the dearth of deals since Bowie bonds. The primary problem is gathering enough information about the potential cash flow and revenue sources from a pool

\begin{footnotesize}
\begin{itemize}
  \item[195.] See id.
  \item[196.] See id.
  \item[198.] See id.
  \item[199.] Id.
  \item[201.] See Borrowers, supra note 3, at 107.
\end{itemize}
\end{footnotesize}
of assets, which in the area of intellectual property, unlike residential mortgages, has had little groundwork laid.\textsuperscript{202}

2. Far-Reaching Applications

A broader application of the Bowie bonds, is for small or midsize record or publishing companies in the media and entertainment sectors. As mentioned in section A, the companies can retain ownership in the underlying intellectual property and still obtain financing.\textsuperscript{203} Securitization of a smaller company’s intellectual property would help the company maintain its independence from a bigger company and allow an alternative means of raising the necessary capital.\textsuperscript{204}

However, high-tech and bio-tech companies would make a more useful and expansive use of the Bowie bond securitization. Imagine a high-tech company, such as a software or hardware company, which has capital intense Research and Development ("R&D") costs. Since most high-tech companies are “one-product wonders,” they usually have a difficult time making money on the product before they can develop another.\textsuperscript{205} Through securitization of the company’s intellectual property, high-tech companies can tap into their future earnings and keep up with the marketplace.\textsuperscript{206}

Additionally, by placing a value on the company’s intellectual property, a more accurate evaluation of the company’s worth can be made, which helps investors in making their decisions.\textsuperscript{207} The bonds would be inexpensive, non-recourse, and the company would keep any profits accrued that exceed the interest on the bonds.\textsuperscript{208} A possible drawback is that securitization requires a cash flow in the

\begin{itemize}
  \item \textsuperscript{202} See id. at 107.
  \item \textsuperscript{203} See supra Part IV.A.
  \item \textsuperscript{204} See id.
  \item \textsuperscript{205} See Haber, supra note 164, at 93.
  \item \textsuperscript{206} See id.
  \item \textsuperscript{207} See id.
  \item \textsuperscript{208} See id.
\end{itemize}
seven-figure range or higher, which in most cases should not be hard to meet.\textsuperscript{209}

Now imagine a small bio-tech company that invents a drug, but lacks the resources to make and market the drug.\textsuperscript{210} After inventing the drug, the company then transfer the patent or intellectual property to a big company willing to pay royalties or licensing fees for a certain number of years.\textsuperscript{211} If, however, the company used asset-backed securitization of the patent, the company could instead use that income stream to raise more capital.\textsuperscript{212} Additionally, the company would not have to worry about losing everything if they go bankrupt, the securitization would provide more money today than signing for a personal loan with a bank. And for potential investors, as mentioned before, placing a value on the intellectual property gives a more realistic evaluation of the company's worth.

If the Bowie bond type financing can be successfully applied to the patents or intellectual property of music/publishing houses, or hi-tech/bio-tech companies, many more intellectual property endeavors can be undertaken and utilized. The hazard of consolidation and loss of independence due to lack of resources would be drastically reduced. The upside that a properly structured securitization offers is too valuable to ignore.

\textbf{V}

\textbf{Conclusion}

Asset securitization is one of the most notable financial innovations of the last twenty years.\textsuperscript{213} 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 capital markets; investment bankers generating income by underwriting, making markets in, and trading asset-backed securities; and

\textsuperscript{209} See \textit{id}.
\textsuperscript{210} See Thomson, \textit{supra} note 146, at 31.
\textsuperscript{211} See \textit{id}.
\textsuperscript{212} See \textit{id}.
\textsuperscript{213} See Shenker & Colleta, \textit{supra} note 46, at 1370.
investors preferring highly rated securities with greater protection from downgrading than traditional debt and often with greater yields than securities of comparable credit quality.\textsuperscript{214}

"Bowie bonds" marked the opening of a new financing method to a largely untapped intellectual property market. The amazing potential and applicability of the Bowie bonds should not be understated. With the vast amount of wealth in the intellectual property market, it would be imprudent not to utilize this rapidly growing property base. So, \textit{is the world ready for a brand new beat?}

\textsuperscript{214} Id.