

SPECIAL REPORT

Asset-Backed Securities

DCR Comments on Music Royalty Securitizations

EXECUTIVE SUMMARY

The purpose of this article is to address some of the issues that Duff & Phelps Credit Rating Co. (DCR) believes are important in music intellectual property securitizations. This piece highlights the framework DCR implements when analyzing a music royalty-backed transaction. One must note that these transactions and DCR's approach are constantly evolving. Therefore, DCR's criteria should be treated as a work in process.

DCR has rated six major securitization transactions backed by the royalty income generated by music. To date, all of the securitizations DCR has rated have been structured by The Pullman Group. The first of these securitizations was a \$55 million transaction that securitized the royalty income from a music catalog owned by David Bowie. These "Bowie BondsTM", as they came to be known, were the first of their kind and created an avenue for artists to attain immediate financial compensation for their life work.

The Bowie deal was followed by the Motown transaction in June 1998. The Motown transaction, which was three separate but nearly identical issuances, securitized the writer's share of publishing rights owned by the songwriting trio of Edward Holland, Brian Holland and Lamont Dozier. Holland, Holland and Dozier are responsible for writing 70 Billboard hits, including many

classic Motown songs of the 1960s and 1970s such as "Baby Love" and "Stop In The Name Of Love."

In December 1998, DCR rated the Ashford and Simpson securitization that was collateralized by intellectual property owned by Nicholas Ashford and Valerie Simpson-Ashford and their affiliates. Ashford and Simpson are one of America's most popular songwriting duos and are responsible for several Billboard top 40 hit songs, including "I'm Every Woman" and "Solid."

Most recently, DCR rated a music royalty transaction that securitized the James Brown music catalog. The notes were secured by certain intellectual property rights to approximately 750 songs created by James Brown. During his career James Brown amassed a total of 98 entries on the Billboard's top 40 R&B Chart, with 19 of his songs reaching No. 1. Among his best-known hits are "Papa's Got a Brand New Bag", "I Feel Good (I Got You)", and "It's a Man's World."

This article offers a general overview of issues in the music securitization arena, although more emphasis will be placed on the transactions DCR rated in the last year. This asset class has evolved considerably since the issuance of the Bowie BondsTM; therefore, the James Brown transaction most accurately reflects DCR's current rating approach to music royalty securitizations.

1. Bowie Bonds are a registered trademark of The Pullman Group.

DCR

CHICAGO



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Copyrights

The asset that is securitized in these transactions typically consists of the cash flow streams generated from ownership interests in copyrights relating to a catalog of songs. The ownership interests can be those shared by a songwriter, performer, publisher or manager. In its simplest form, owning the copyright to a song entitles the holder to exploit the music, as well as to receive royalty income from various parties. As discussed below, music copyrights can be exploited in many ways by different parties, all of which generate royalty income for the persons entitled to receive the corresponding cash flow. For securitization purposes, the bankruptcy-remote trust receives these monies for the benefit of the investors.

Copyrights are a federally protected interest in intellectual property that gives the owner of the copyright certain rights for a limited amount of time. The most important of these are the rights to transfer this interest to others and to receive royalties. Copyright law was established by the Federal government through the Copyright Office. Until 1978 the law stated that a copyright had an original term of 28 years, with a 28-year extension available upon renewal. Per the 1976 Copyright Act, a copyright created after January 1, 1978, now lasts either 50 years beyond the life of the writer of the song or 75 years from the date of writing the song. Any song created prior to 1978 has an additional 19-year extension tacked onto its initial 56-year term. After the copyrights expire, the intellectual property becomes part of the public domain and no royalty is owed for using the material.²

Sources of Revenue

As can be seen at the top of page 3, the sources of revenues that are generated from the copyrights are diverse and sometimes overlapping. The most fundamental interests in the music copyrights belong to the writers and publishers of the material, and these interests can be broken down between many parties that were co-writers or co-publishers of the music. Alternatively, the writer and publisher can be the same person.

The owner of the copyright or the “publisher” has the right to exploit the asset by licensing, selling or renting the musical composition to other parties for a royalty payment. Publishing royalties are generated when, among other things, the song is covered by another artist, sampled by a rap star, used on a movie soundtrack or synchronized into a commercial. Publishing royalties are made up of two parts: the publisher’s share and the writer’s share. Whenever a song is used by a third party, a payment flows to the publisher, who in turn pays the songwriter his or her portion. Often the songwriter and publisher are the same person and entitled to both portions of the payment.

The music catalog must be promoted by an entity that economically benefits from the successful exploitation of the music. In most cases the publisher’s administration fee is established as a percentage of the gross revenues generated by the catalog. As a result, the administrator benefits from actively marketing the songs. The publisher typically controls the copyrights and hence determines how to ad-

Transaction Name	DCR Rating	Number of Copyrights	Collateral Type	Placement Agent
Jones/Tintoretto Entertainment Company LLC (David Bowie)	A-	287	Publishing Rights and Recording Rights	Pullman Group
Edward Holland LP	A-	312	Writer’s Share of Publishing Rights and Performance Royalties	Pullman Group
Lamont Dozier LP	A-	312	Writer’s Share of Publishing Rights and Performance Royalties	Pullman Group
Brian Holland LP	A-	312	Writer’s Share of Publishing Rights and Performance Royalties	Pullman Group
Nick-O-Val, LLC (Ashford and Simpson)	A- BBB	247	Publishing Rights, Recording Rights and Performance Royalties	Pullman Group
James Brown, LLC	A-	750	Publishing Rights, Recording Rights and Performance Royalties	Pullman Group

2. Paraphrased from Krasilowsky, M. William and Shemel, Sidney. *This Business of Music*. New York: Billboard Books, 1995. pp. 159-164.

Sources of Revenue³	
Publishing Royalties	The owner of the copyright in the musical composition receives income from licensing, sale or performance use of the copyrighted songs (from record companies and other users). Royalties received include a portion payable to the songwriter, as well as a portion payable to the publisher.
Mechanical Royalties	Monies paid by record companies to publishers for the right to use songs on records, regardless of whether they are originals or cover versions.
Performance Royalties	Payments from broadcast and public performances are collected by performing rights societies such as ASCAP, BMI or SESAC and their foreign affiliates from radio and television (among many other users) that broadcast or use songs owned or written by members of their society. Royalties are distributed to writers and publishers under formulas established by each society that determine the appropriate distribution to each writer and publisher.
Synchronization Royalties	Songwriters and copyright owners receive payments when a song they own and/or composed is synchronized to a film or videotape, regardless of who performs the song. Royalties are based on negotiated agreements between the copyright owner and the licensee.
Artist Royalties	Artists receive payments under their contracts with record companies based on record sales. The royalties are only for the recording artist, not the songwriter or publisher.

ministrate the music. Songwriters and co-publishers, while entitled to a portion of the songs' royalties, do not dictate the catalog's usage. Songwriters and co-publishers are in a passive role and, consequently, are dependent on the publisher's ability to generate income from the music.

The owners of copyrighted songs often sign licensing contracts with record companies that entitle the record company to sell the artists' music. Most often the record company owns the record master to the studio recording of a rendition of a song. The owner of the record master typically has the right to package and sell the song in any fashion it feels is appropriate (i.e., music clubs, box sets, greatest hit albums). The publisher receives a royalty payment from the record company through this contract. In addition, the artist may have an agreement with the record company that entitles him or her to receive royalties from record sales. Further, the compensation that songwriters receive every time one of their songs is recorded and sold is called a "mechanical" royalty.

Songwriters and publishers are also members of a performing rights society, such as ASCAP, BMI or SESAC. A performing rights society collects performance royalties from radio and television broadcasts and public performance of the copyrighted work. Royalties are distributed to writers and publishers under formulas established by each society that determine the appropriate distribution to each writer and publisher.

Ultimately, the sources of royalty income are complicated and can be derived from multiple sources. DCR's concern is that all future royalty income owed to the trust can be traced, monitored and audited.

The Assets

In general, the most important questions that must be addressed in music royalty-backed transactions concern the assets being securitized. What is being securitized? What does owning the assets entitle the trust to and for how long?

DCR's first task is to determine exactly what makes up the assets. The asset in music royalty securitizations can be, among other things, copyrights, agreements between the writers and the publisher regarding the writer's share of publishing rights, the publishing rights themselves or record masters. It is important to determine what individuals or companies are party to these agreements and what their roles are in the relationship. More specifically, does the seller have the right to receive the royalty payments from the assets? In addition, does the seller have the right to sell the assets? It would be difficult, if not impossible, to securitize the assets if the answer to either of the previous questions was "no."

The trust should benefit from the copyrights during the entire term of the transaction. The legal right to exploit the intellectual property must not expire either as a result of law or as a result of contract before the maturity of the transaction. DCR must consider when each of

3. Information obtained from materials provided by Robbins Spielman Koenigsberg & Parker, LLP.

the copyrights expires and how such laws might impact valuations.

Cash Flow and Valuation Analysis

The noteholders of the securitization have three sources of repayment: the cash flows generated from the copyrights (royalty income), the liquidation proceeds from the sale of the copyrights, and any credit enhancement in the transaction. The first two sources of repayment require DCR to analyze both the cash flow-generating ability of the copyrights and their recovery values if liquidation is required.

DCR believes the assets must display significant revenue-generating history in order to be securitizable. The cash flows should show earning stability over a number of years and ideally exhibit an upward trend. In a typical music royalty transaction, debt will have to be serviced for a term of 10-20 years. Cash flows cannot be coming from "one hit wonders" that will fall off after only a few years.

DCR looks to the historical revenue generating ability of the assets to develop a base case assumption. DCR then creates different cash flow scenarios for the transaction. For example, if the historical numbers reveal that earnings have been very stable over a number of years, DCR might assume 0% growth in the revenues over the life of the transaction. Should the historical cash flows show signs of variability, DCR might stress these numbers more heavily by implementing a negative growth assumption.

If the annual cash flows are inadequate to repay the bonds, then the noteholders will look toward the recovery proceeds from the liquidation of the music catalog. A portfolio is valued by applying a multiple to its most recent earnings or an average of the last five years' earnings. DCR uses the aid of an independent appraisal to understand the music portfolio's value to potential buyers as well as to learn how the portfolio might be valued in the open market.

On the other hand, DCR recognizes that a liquidation mechanism is only necessary if the music catalog is generating inadequate revenues to amortize the bonds in a timely fashion and that the liquidation process might occur in less than ideal circumstances. Therefore, DCR is concerned with how much the portfolio is worth on day one of the securitization, as well as its value during certain periods of the transaction. It is assumed that the assets will not generate their full value in a "fire sale" situation, so DCR analyzes what valuation multiple

is necessary to liquidate the assets and pay the bonds in full.

Structure and Credit Enhancement

In order to securitize the assets, the ownership interest in such assets must be transferred to a bankruptcy-remote special-purpose vehicle (SPV) via a "true sale." The sale entitles the trust to all the revenues that are generated by the assets throughout the term of the transaction. In the situation that a bankruptcy court believes the transfer from the seller to the SPV is a secured financing and not a sale, then DCR requires an opinion that the SPV has a first-priority perfected security interest in the assets for the benefit of the noteholders. For copyrights, DCR requires both UCC filings and copyright office filings to achieve the perfected status. In addition, the trust must have the ability to sell all or a portion of the assets if necessary. DCR relies on legal opinions, title searches, tax returns, officers' certificates and UCC filings to determine whether a clean and unencumbered ownership interest can be transferred to the SPV.

There are a number of different structural features that can be implemented to ensure the security of the bonds. In most cases DCR prefers that all cash generated by the assets flow into the transaction and remain in the transaction until the bonds are repaid in full. DCR believes the sellers should not benefit from their residual interest in the assets until the bondholders receive their investment, although an unusually strong revenue stream might warrant an exception to this rule.

Due to the lumpy nature of incoming revenue in music royalty securitizations, the transaction's structure must address the liquidity needs of the notes. A cash reserve can be established as enhancement for the timely payment of interest or the ultimate payment of principal. The reserve would preferably be funded on the transaction's closing date, but an enhancement-building instrument can be put in place.

Another concern that can be addressed in the structure is the formation of a tax reserve. The tax obligations of the sellers must be addressed in a tax reserve-type mechanism if the seller's tax treatment is "debt for tax." In this situation the sellers will owe taxes as the revenues are generated, but the sellers might not have the financial ability to pay those taxes when owed. DCR must look to the financial strength of the sellers to determine the appropriate mechanism.

Conclusion

While this article highlights some of the topics DCR feels are important in music royalty securitizations, it only scratches the surface of a much larger picture. DCR foresees endless possibilities involving intellectual property

transactions inside and outside of the music royalty sector. To date, issuers have not securitized patents, trademarks and certain copyrights, although DCR believes that music royalty transactions have opened the door for these and many other assets. **DCR**

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