Legal aspects of IP securitisation in Switzerland

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Traditionally, 'tangible' assets such as credit card receivables, mortgages and loans were generating the cash flows to be securitised. But since the 1997 issuance of the Bowie Bonds, intangible assets have been used for securitisation. In 2002, the World Intellectual Property Organization (WIPO), Geneva declared 'securitisation of intellectual property assets' a new trend particularly for small and middle-sized companies, and the number and volume of these deals is growing.

New asset class and Switzerland
Switzerland holds a vast reservoir of intellectual assets as it figures among the most innovative European countries, with a number of leading multinational companies and important industries in pharmaceuticals, chemicals and biotech, as well as in branded goods, machine tooling and information technology. Switzerland is also the home of important sports organisations such as the International Olympic Committee (IOC) and the world and European governing bodies of football (FIFA and UEFA) owning important licensing rights. Also the efficient legal system and the tax privileges for holding and domiciliary companies motivated numerous international companies to set their headquarters in Switzerland and to bring in their global intellectual property portfolios. For example, Mexico's biggest producer of dairy products recently moved its entire trademark portfolio to Switzerland.

Characteristics of Intellectual Assets
Intellectual Assets (IA) encompass, as a start, the legally protected intellectual property rights (IP) of a company. However, the framework for IP protection differs from country to country. Under Swiss law, IP rights include patents, trademarks, copyrights, industrial designs, and chip-designs, whereas trade secrets, business processes or merchandising/franchising rights do not fall under IP rights, although they are also legally protected. However, irrespective of this legal distinction, any kind of know-how, idea or invention (1) that is put on record in some form, and (2) from which value can be extracted, also falls under the definition of IA.

To be eligible for securitisation, IA has to generate sufficiently sustainable cash flow, and such cash flow, as well as the risks potentially affecting it, need to be ascertainable with current valuation methods. Preferably, there also exists historical asset performance, which would allow projection for future cash flows. IA may be cash flow producers, mainly through royalty payments from licensing contracts allowing third parties to commercially exploit the IA. But compared to tangible assets, IA cash flows, typically, are more variable as they often fully or partially depend on market conditions such as sales volumes by licensees. Also, IA feature more complex risk profiles than tangible assets because their cash flows are not only affected by market and company risk, but also by legal risk, which is different for each IA class and jurisdiction. Still, as IA also show considerable advantages, rating agencies, valuation specialists and accounting firms have learned to deal with these specifics over the years.

Possible advantages of IA securitisation
IA-owing companies:
• Utilisation/leverage of (often times) unused or illiquid assets
• No or limited correlation of credit rating with overall company rating
• Lower capital cost, longer maturity and higher flexibility compared to loans
• Use of IA as funding source without giving up IA-ownership

Investors:
• Investment in separate, otherwise unavailable asset class
• Diversification of portfolio with uncorrelated asset risks
• High credit spread composed to similarly rated assets
• Benefits from investment opportunities in a still immature market

Because of the complex risk profile of IA, a comprehensive due diligence by legal and financial IA specialists is crucial when setting up a securitisation project. Furthermore, an experienced IA specialist (rather than the Originator/IA owner) as Servicer may help protecting the cash flow stream.
**Deal structures**

Rarely, an IP right itself is directly securitised, but rather the revenue streams it generates through claims to receivables from licence contracts. Key features of the two basic IA securitisation forms are described hereafter.

Indirect securitisation (Figure 1). This form of IA securitisation is dominant in the market. Not the IP right but the licence fees/royalties stemming from it are pooled and transferred by the Originator, normally the IA owner, to an SPV. The SPV issues securities in the capital market. To mitigate investor risk, this basic structure is sometimes amended by granting security over the IA that generate the receivables and other elements from direct securitisation structures.

Direct securitisation. The Originator transfers the IA itself to an SPV, by way of either sale or pledge. Through a sale, the Originator loses ownership in the IA, thereby, in principle, giving up all rights to use, exploit and manage the IA. On the other hand, the sale of the IA to the SPV is bankruptcy remote. Nevertheless, direct securitisation is rare since only few companies are willing to give up their IA, which often represent an essential part of a company’s assets. In practice, the disadvantage is sometimes mitigated if the SPV licenses the IA back to the Originator.

**Links to Switzerland**

Structurally, the following links to Switzerland exist in IA securitisation:

- Cash flow stream under Swiss law. Whenever receivables to be transferred in securitisation are governed by Swiss law, the legal requirements on the assignment of claims must be complied with.

Pursuant to Swiss conflict of law rules, Swiss substantive law may apply by virtue of a Swiss domicile of the originator of the claim or, quite frequently in international transactions, by agreement between the parties.

IP rights registered in Switzerland. Since IP rights are national, the principles of Swiss law must be considered whenever IP rights registered in Switzerland or otherwise subject to Swiss law are directly or indirectly securitised. Being a very lucrative market, Switzerland is a hub for intellectual property registration at the international level.

Originator or SPV domiciled in Switzerland. International companies choose to set up Swiss subsidiaries to commercialise their IA and to benefit from tax advantages.

ABS listed in Switzerland. IA securitised ABS, issued either by Swiss or foreign issuers, can be listed on the Swiss Stock Exchange (SWX), which has adopted special guidelines (currently under review) for the listing of ABS supplementing the listing rules for debt securities. While listings so far have been few, in light of the requirements of the EU Prospectus Directive the straightforward listing regime of the SWX (e.g., foreign law issues and governing law, offering documents in English are accepted) may attract more issuers in the future.

Although the Swiss market is attractive for IA securitisation, just one major Swiss driven deal was structured so far: In November 2001, FIFA completed what is believed to be the world’s first securitisation of sports marketing rights. FIFA securitised receivables under sponsorship agreements for international football events.
including the 2002 and 2006 FIFA World Cups, in a private placement of notes issued by a Swiss SPV.

**Transfer of Swiss receivables**

**True sale**

In international securitisations, receivables are transferred by way of true sale. Although not a legal concept in Switzerland, Swiss law is flexible enough to satisfy the prerequisites of true sale provided the transaction terms are at arms' length. The purchase price for the receivables must reflect fair market value by taking account for all IA specific credit risks. Hence, the complexity of IA valuation is one of the key Swiss law challenges in IA securitisations.

The transfer of receivables is governed by art. 164 ss. of the Swiss Code of Obligations (CO; assignment of claims) and art. 184 ss. CO (purchase contracts). In order to assign receivables, there has to be

- a commitment between assignor (seller of receivables) and assignee (purchaser)
- a transfer of the receivables in writing
- no legal or contractual assignment restrictions.

Debtor notification is not required for the validity of the assignment, yet for the enforcement and protection of the assignee's rights. Absent notification, a bona fide Debtor could (1) validly discharge its debt by payment to the assignor or by means of set-off with any (pre-) existing claim against the assignor; (2) raise pre-existing legal objections against the assignor/assignee.

**Bankruptcy remoteness**

Generally, receivables validly assigned are bankruptcy remote. Receivables stemming from IA licensing contracts represent current and future (revolving) cash flow. Swiss law provides for the assignment of future claims as long as they are sufficiently specified. However, in the Originator's insolvency, future receivables (i.e. assigned receivables not come into existence at the time of adjudication of bankruptcy) would not be deemed to have been validly assigned and transferred to the SPV. Rather, receivables accruing from the start of bankruptcy proceedings would fall into the bankrupt's estate.

Art. 69 ss. (asset transfer) of the 2004 Swiss Merger Law could solve the issue regarding future receivables. The statute allows a company to transfer all or part of its assets and liabilities to another legal entity by a single operation of law, and without Debtor notification. But so far, the disadvantages of this statute's requirements like mandatory publication of an inventory of transferred assets prevailed. Also, transfers of the Originator's entire position under licensing or other agreements are rare in Switzerland, because consent of all contract parties is required. In the discreet securitisation environment, transfer by way of assignment (CO 164 ss.) is therefore still prevalent.

However, depending on the circumstances the following options may improve the protection of the investor's interests:

1. Collection account for the receivables in name of Originator, with:
   - separate bank accounts for present and future receivables
   - proxy and pledge over account for SPV (or joint account, blocked account)
   - no commingling with Originator's other assets (separate account)
   - frequent sweeps

2. Diversion of cash flow:
   - collection account in name of SPV, and notification of Debtor(s) to no longer pay onto Originator's account

3. Conditional assignment of IA to SPV with automatic transfer of IA ownership to SPV, triggered either by a decrease of the Originator's and/or assets' performance below a predefined level or by a credit event in relation to the Originator and/or SPV.

**Figure 2: Requirements for the actual assignment or pledge regarding each type of IP rights**

<table>
<thead>
<tr>
<th>Right</th>
<th>Protection term</th>
<th>Assignment</th>
<th>Pledging</th>
</tr>
</thead>
<tbody>
<tr>
<td>Patent</td>
<td>usually 20 years registration</td>
<td>written form plus registration</td>
<td>written form plus</td>
</tr>
<tr>
<td>Trademark</td>
<td>may last indefinitely registration</td>
<td>written form plus registration</td>
<td>written form plus</td>
</tr>
<tr>
<td>Industrial design</td>
<td>25 years</td>
<td>written form plus registration</td>
<td>written form plus</td>
</tr>
<tr>
<td>Copyright</td>
<td>normally 70 years plus life of author or 50 years plus life of author for software</td>
<td>No special form (It is contentious whether moral rights can also be assigned)</td>
<td>No special form</td>
</tr>
<tr>
<td>Chip-design</td>
<td>10 years or two years if the chip-design has not been registered</td>
<td>written form plus registration</td>
<td>written form plus</td>
</tr>
</tbody>
</table>
However, enforceability of such conditional assignment and other investor protection measures under applicable bankruptcy laws has to be assessed on a case-by-case basis.

In relation to the bankruptcy remoteness of the SPV the usual precautions for ringfencing the SPV (limited recourse, no petition, limitation of set-off) are put in place.

**Due diligence**

As part of the due diligence verification should be made that (1) there are no legal or contractual impediments against a transfer of receivables (transfer prohibitions, consent required by third parties); and (2) a waiver of set-off is requested for any claim the Debtor has against the Originator.

The specifics of the concrete licensing contracts that produce the securitised receivables may require further due diligence.

**Transfer of IP rights**

**Transfer and pledging of IP rights**

Transfers of IP rights are normally limited to those not being actively exploited. Another option is to pledge IP rights so that the Originator will retain control over its IA and the Investors will have collaterals to satisfy their claims.

The transfer or pledging of IP rights requires both the commitment to assign or pledge and the actual transfer or pledging of the right. While the former is not subject to specific form, the latter has often to be conducted in written form. Although the registration of an assignment or pledging is not required as a validity prerequisite, it is strongly recommended, as it will enable the assignee or pledgee to defend its rights against third persons.

Figure 2 shows the requirements for the actual assignment or pledge regarding each type of IP rights.

**Bankruptcy remoteness**

If the Originator goes bankrupt, the IP rights assigned to the SPV are usually bankruptcy remote to the extent that the transaction was done at arms’ length making the appropriate valuation of IP rights key. All the more because Swiss tax law allows only limited recourse to the Originator, and the amount is determined by the specifics of the transferred assets.

If the IP rights are pledged (rather than assigned) to the SPV, they are subject to the foreclosure procedures stipulated by Swiss bankruptcy law. By means of forced sale by the trustee in bankruptcy, patents, trademarks, industrial designs and chip designs can be used to fulfill Investors’ claims and they are granted priority from the other creditors of the bankrupt Debtor. However, under Swiss law, copyrights on not yet published work are not subject to forced sale, neither are moral rights.

**Due diligence**

Either for the transfer or pledging of IP rights, it is critical to determine the inherent value of those rights at stake by due diligence. The most important aspects to be covered include:

- Title to the rights, particularly in case of invention or work created in employment relationships, it has to be ensured that the employer has secured the rights on such intellectual products by virtue of the law or by agreement.
- Status of the rights, including whether the IP rights in question have already been granted and well maintained, and when they eventually expire.
- Infringement suits, administrative proceedings or other adverse claims relating to intellectual property outstanding or threatening by or against the IP-owner.
- Possible new developments that make the underlying IP asset obsolete.
- Absence of conflicting commitments (such as licensing or joint ventures, or covenants in financing agreements) or collateral arrangements.
- Measures taken by the originator to safeguard confidential information and know-how.

**Additional issues for Swiss Originators/SPVs**

**Data protection**

If non-anonymised customer data (names of customers, amount of receivables, etc.) are being transferred between the Originator and the SPV or Servicer, the Swiss Federal Data Protection Law must be considered. A transfer of personal data is only permissible under certain conditions. This will have to be examined based on a detailed outline of the data actually transferred. The export of data out of Switzerland is subject to the further condition that the national law where the data receiver is located foresees equivalent data protection or that the receiver obligates himself to comply with Swiss data protection provisions. Also, certain notifications may have to be made with respect to data relating to legal entities (and not natural persons) because equivalent data protection is not deemed being provided in many of the EU member states.

**Money laundering**

Activities of so-called ‘financial intermediaries’ are subject to regulation under the Swiss Money Laundering Act. Regulated activities include financing by means of factoring and procurement of payment transaction services. An SPV or servicer engaging in such regulated activities in Switzerland needs to comply with, inter alia, licensing and due diligence duties.
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**Tax**

Income and capital tax. A Swiss SPV is liable to income tax on its profits and capital tax on its equity at ordinary rates on the federal, cantonal and communal level. However, expenses, here primarily interest payments and, in the case of IP rights, amortisation, are fully tax-deductible. There is legislation in Switzerland addressing thin-capitalisation, i.e. minimum taxable equity requirements and maximum tax-deductible interest payments, and permissible annual amortisation. Some cantons apply to SPVs very modest thin-capitalisation limitations, and will be open to discuss amortisation rates, all leading in effect to minimal aggregate capital and income taxation.

**Withholding and stamp tax**

Interest paid by a Swiss resident SPV is not subject to withholding tax (35%) unless the instrument under which interest is paid is classified as a 'Bond' or 'Debenture' for Swiss withholding tax purposes. However, where ABS can be held pursuant to their terms at any time by more than 10 non-bank creditors, they will be characterised as Bond and Swiss withholding tax will in principle apply to the entire amount for the entire term and, in addition, a securities issuance stamp tax on the nominal amount at the rate of 0.12% per year will apply. Swiss withholding tax is also triggered if the Swiss SPV has more than 20 non-bank lenders in the aggregate. In such a case the aggregate of loans and debt instruments (excluding Bonds) is classified as Debenture and Swiss withholding tax applies to the interest paid by the Swiss SPV to any non-bank. In addition, a securities issuance stamp tax at the rate of 0.06% per year will apply. Note that Swiss law does not limit itself to looking at lenders of record, and in some cases secondary relationships giving a non-bank an economic interest in the loan debt instruments issued by the Swiss SPV can trigger Bond—or Debenture-classification. For foreign investors the 35% withholding tax is reimbursable according to the applicable double taxation treaty.

Depending on the investors, there are techniques to avoid withholding tax and stamp duty on debt financing entirely by taking advantage of the rules on permitted non-bank creditors (bank lenders only and/or restricted number of non-bank lenders) and/or by using specific types of financial instruments. Alternatively, the ABS can be issued by an offshore SPV, which pays the proceeds to a Swiss SPV holding the IA. Here, in order to avoid Swiss withholding tax and issue stamp on the ABS, it must be safeguarded that the tax administration pre-approves the asset transfer from the Originator to the Swiss SPV as a true sale and the SPV as being independent from the Originator.

A Swiss SPV is liable to 1% stamp tax on any contributions to its nominal or other capital (less an aggregate allowance of SFr250,000). Debt reclassified into hidden equity under thin-capitalisation rules is not subject to the tax. Finally, the transfer of receivables and IP rights is not subject to stamp taxes, nor is there a withholding tax on licence fees.

**Value added tax**

Neither the sale from the Originator to a Swiss or foreign SPV nor the collection of receivables is subject to Swiss Value Added Tax. The Swiss SPV will, however, not be entitled to input tax deductions on supplies used in relation thereto including services for the issuance of the ABS. The Originator will be liable to VAT at the standard rate of currently 7.6% on the sale of IP rights to a Swiss SPV.

To eliminate anomalies when services are supplied internationally, the place of supply for so-called 'intangible services' is the place where the recipient of such service has established his business or has a fixed establishment. Such services include the sale of IP rights. Accordingly, the Originator will normally not be liable to Swiss VAT if the sale is effectively to a foreign SPV and if the sale is properly documented and accounted for.

**Conclusion**

While IP securitisation is still in its early stages proper, due diligence and refinements of transaction structures and features should allow market participants to cope with the particulars of using IA as underlying. Switzerland is both economically and legally well positioned to benefit from this development.

**Notes:**

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