

Review of Legal Risks of Assignment of Patent Securitization Underlying Assets and the Way Forward for Improvement

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Abstract: Patent securitization is the securitization of patents with patent assets as the underlying assets. Among them, the underlying assets with predictability, transferability and authenticity often complete the transfer of underlying assets through debt session, but there are certain legal risks due to the imperfection of China's legal system. In this regard, the corresponding improvement path is proposed: firstly, to clarify the legal standard of true sale; secondly, to give the asset-backed special plan an independent legal status; thirdly, to improve the system of future claim assignment.

Keywords: Patent Securitization, Underlying Asset Transfer, Special Purpose Vehicle

1. Introduction

Under the trend of economic globalization, a knowledge-based economy has become increasingly important, and the competition around intellectual property rights in developed countries and advanced regions has become more and more intense. Patent securitization has become a core means to promote the realization of patent value and thus enhance competitiveness due to its patent utilization advantages and has become a policy hotspot of its unique financing advantages, such as integrating intellectual property and financial capital[1].

China has maintained a continuous focus on patent securitization and vigorously promoted it. 2015 "Several Opinions on Deepening the Reform of Institutional Mechanisms to Accelerate the Implementation of Innovation-driven Development Strategy" proposed to encourage the exploration and development of; 2018 "Guiding Opinions on Supporting Hainan's Comprehensive Deepening of Reform and Opening-up" included it as a replication and promotion project in the free trade zone. Under the strong impetus of relevant policies, the number of patent securitization products and financing scale in China have increased substantially in a short period of time. The cumulative issue size reached 14.918 billion yuan as of December 31, 2021. With the emergence of patent securitization products in the market, however, due to the lack of a complete theoretical system and legal system as a support, the transfer of underlying assets in patent securitization financing faces multiple legal problems and triggers legal risks.

2. Logical Starting Point for the Transfer of The Underlying Assets of Patent Securitization

2.1. Explanation of The Concept of Patent Securitization Underlying Assets

Patent securitization is a breakthrough in the asset securitization system at the level of underlying assets, and is a new model of securitizing intellectual property as the subject matter of securitization transactions. Scholars have also focused differently on its definition[2], with some focusing on the asset-building component and others on the relationship between securitization and financial development[3]. On the whole, patent securitization is a process in which the sponsor packages its less liquid patent assets that can generate certain income in the future to separate them from other assets and form the underlying assets, and then builds securities that can be freely circulated in the capital market through a series of financial processes based on the expected income of the underlying assets.

The underlying assets in securitization are those assets that lack liquidity but at the same time have the possibility of future returns and have certain common characteristics. The underlying assets of patent securitization supporting securitization operation are patent assets. Patent assets are the resources that

are expected to bring economic benefits collectively, including patent ownership, patent claims and other economic rights. Patent assets as underlying assets is the biggest difference between patent securitization and other asset securitization[4].

2.2. Legal Definition of Patent Securitization Underlying Assets

There are numerous doctrines on the criteria of securitizable assets, whether it is the six-point theory summarized according to the securitization varieties[5] or the eight-point theory considered by Wang Kaiguo and others[6], all of them are the criteria of economic characteristics in an ideal state. In contrast to the economic characteristics of the underlying assets, the legal standards of the patent base are more crucial in guiding the development of securitization regulation.

The predictability of the underlying assets is a prerequisite to ensure the repayment of principal and interest to investors, and patent assets can only be securitized if the future cash flows can be predicted and remain relatively stable.

The underlying assets should be legally transferable. While the foreseeability above is a prerequisite for the possibility of securitization, the transferability of the underlying assets can truly transform this possibility into feasibility. The act of transferring the underlying assets must complete the transfer of all interests and risks as a real sale in the legal sense, and cannot be defined as an act of financial guarantee at the legal level.

Authenticity of the underlying assets. The authenticity of the underlying assets requires the authenticity of the rights and the authenticity of the value of the patent assets. The authenticity of the rights of patent assets includes the stability of the rights attributes, i.e., the patent rights really exist and belong to the patentee; the authenticity of the value of patent assets requires that the patent assets are valuable and the valuation results are reasonable.

2.3. Patent Securitization Underlying Asset Transfer Method

The transfer of the underlying assets is a crucial part of patent securitization, so the bankruptcy isolation system is designed to avoid the occurrence of the bankruptcy of the originator and the original equity holder impacting the cash flow of the underlying assets. The sale of the underlying assets to be securitized by the originator to the SPV is called the transfer of the underlying assets, and the change of the subject of the rights of the underlying assets is realized through the transfer. There are various ways to transfer the underlying assets, such as trusts, claims assignments, etc. Regardless of the transfer method, the fundamental purpose of transferring underlying assets is to divest the sponsor's assets from the underlying assets. The underlying assets are not affected by the sponsor's bankruptcy when the sponsor is voluntarily or involuntarily insolvent. In the legal trust relationship, the SPV is entrusted by the promoter to manage and dispose of the underlying assets in its own name. As an independent entity, the SPV can fully accept the rights and risks of the underlying assets to realize the separation between the underlying assets and the promoter's own property, giving full play to the natural advantages of the trust system. The SPV becomes the creditor of the contract instead of the promoter. The credit risk of the claim is transferred by the originator to the SPV at the same time. The assignment of claims can better meet the requirements of risk segregation, and it is the most common method of transferring underlying assets in China's patent securitization due to its simple procedure and low cost.

3. Review of the Legal Risks of Transferring the Underlying Assets of Patent Securitization in China

To suppress the risk of transfer of underlying assets, we mainly rely on the real sale and the function of special purpose vehicles. However, in the transfer of the underlying assets of patent securitization in China, there are problems such as unclear criteria of "true sale", lack of legal subject status of special purpose vehicles and lagging system of future claims assignment, which make it difficult to play the role of insolvency isolation.

3.1. The Legal Standard of "True Sale" is Unclear

A true sale means that the special purpose vehicle fully accepts the benefits and risks of the transferred underlying assets as the transferee. In patent securitization, the judgment of whether the legal effect of the right to proceed or claims of the patent asset is separated from the sponsor's property is based on the

legal true sale standard.

A true sale must be conducted through certain legal channels. At present, the most widespread way to achieve the true sale of underlying assets in China's patent securities market is the transfer of claims, in which the originator withdraws from the debt relationship by transferring the patent claims it enjoys, while the special purpose vehicle pays the corresponding consideration to obtain the corresponding claims to join the debt relationship. From the current legal provisions involving true sale in China, the duties of the original equity owner include the transfer of the underlying assets to the special purpose vehicle, but the standard of "true sale" in the transfer process is not mentioned. The guideline on true sale in recognition of the transfer of financial assets in AS 23 - Transfer of Financial Assets can be used as a reference standard for judging true sale, but the guideline is mainly based on accounting regulations and is not limited by the transfer of rights at the legal level. In short, China lacks the meaning of true sale at the legal level and the judgment standard at the legal level, so the court will lack the legal basis to judge the nature of the act.

3.2. Lack of Legal Subject Status of Asset-Backed Special Plans

The special purpose vehicle is the core vehicle and key link in the securitization of patent assets, which is where the patent assets can be structured for financing and the basic principle and inherent mechanism, and is an important vehicle to realize the bankruptcy isolation system. In China's practice, the asset-backed special purpose plan (hereinafter referred to as special purpose plan) introduced by the SEC is used as the special purpose institution instead of the traditional trust model or company model. The current rules of special purpose vehicles are innovative arrangements based on the current legal framework and legal environment to promote the securitization of patent assets to expand the scale and obtain stronger market adaptability. However, the adoption of special purpose plans cannot achieve the guarantee real independence of underlying assets. Although special purpose plans have a certain degree of independence with specially established independent fund accounts and custodian service agencies, they are still essentially a series of agreements or contractual portfolio arrangements.[7] The special plan does not have independent legal personality, so it cannot form legal relationship with other participants. Therefore, the securities company introduces the subject of the manager to build the legal relationship of securitization transaction to participate in the patent securitization transaction to become the central role, replacing the special plan to shape the legal relationship function of the structured financing transaction. Although this practice can avoid the bankruptcy risk of the sponsor to a certain extent, it is tantamount to transferring the risk to the name of the securities company, and the bankruptcy risk and the risk of conflation still exist for the investors. Even though the Regulations on Asset Securitization Business of Securities Firms and Fund Management Companies' Subsidiaries give the special management plan a separate account capable of bearing legal liabilities within a certain scope and provide that the underlying assets in the securitization do not belong to the liquidation of the bankruptcy estate, the legal effect of the regulations is of a lower level, and it is difficult to counter the relevant provisions of the Civil Code on the scope of the bankruptcy estate.[8]

3.3. The System of Future Claims Assignment is Lagging Behind

Compared with pure patent rights, the cash flow provided by the claims formed by the right holder through the exercise of the right to use or value the patent is stable and predictable, so it is more widespread to use future claims such as patent proceeds as the underlying assets. However, China has not made detailed provisions on the assignment of future claims, which will hinder the flow of the underlying assets and is not conducive to the smooth implementation of patent securitization.

Whether future claims can be assigned or not is the antecedent issue to whether the securitization of intellectual property can be successfully carried out. China's Civil Code only specifies in the factoring contract that the receivables that will be available can be assigned to the factor, and based on the applicable provisions of Article 467 of the Civil Code by reference, it can be inferred that future claims can also be assigned. The unclear point of validity of future claims conflicts with the requirement of insolvency isolation of patent securitization. According to the traditional theory of assignment of claims, the assignment of future claims only takes effect when the claims are established[9]. Until the claim actually occurs, the underlying assets are still owned by the originator and are not transferred to the special purpose vehicle through contract formation. If the originator becomes insolvent before the claim actually arises, the SPE cannot act against the originator's creditors or the insolvency administrator. At the same time the system of notice of assignment of claims and patent securitization is inapplicable under the premise that future claims have transferability. According to Article 546(1) of the Civil Code, an

assignment of debt without notice to the debtor is ineffective against that debtor, thus achieving procedural protection for the debtor. In patent securitization financing, the underlying assets are usually pooled claims. If the notification of the debtor is taken as the antagonistic element of the assignment of claims, the act of notifying the creditors one by one will consume a lot of economic and time costs, which is hardly compatible with the interests of efficient commercial claims financing.

4. The Way Forward for The Legal Improvement of The Transfer of The Underlying Assets of Patent Securitization in China

Due to the lack of legislation and ambiguity, there is a long way to go to improve the legal system for the transfer of the underlying assets of patent securitization in China. The standardized development and application of patent securitization in China cannot be achieved without the support of the legal system. This paper reshapes the bankruptcy isolation system for the transfer of underlying assets by clarifying the legal standard of true sale, giving the special plan the status of an independent commercial entity and improving the future transfer system.

4.1. Clear Legal Standards for True Sales

The clarification of the legal standard of "true sale" is an institutional guarantee to bring the advantages of the insolvency segregation system into full play. First, the promoter and the SPV should sign the Asset Purchase and Sale Agreement to acquire the underlying assets at a reasonable price. If the price of the acquired assets is obviously unreasonable, there is a risk that the court will use Article 31 of the bankruptcy law to avoid the transfer of the underlying assets. China has not yet established a perfect circulation market for intangible assets and cannot determine the value through the relationship between supply and demand of intangible assets among market players. Therefore, the professional appraisal agency's evaluation price of future patent assets using the income method is more in line with the market's expectation of their value and is more indicative. Secondly, the transfer of the underlying assets is based on the true intention of both parties, which includes the act of transfer and the purpose of transfer. The seller and the transferee of the underlying assets have the real intention to transfer the underlying assets and have the real purpose of realizing the issuance of the underlying asset transfer-backed securities. Again, the transfer of the underlying assets must meet the accounting criteria for true sale in AS 23 - Transfer of Financial Assets[10]. In the case of lease claims and license claims as underlying assets, although the accounting criteria are met, the originator still has the ownership of the leases or licenses, so the true sale can be met by agreeing to a perfection of rights event. Once the perfection event occurs, the originator must transfer ownership to the special purpose vehicle and notify the original patentee to assist in the necessary rights change, thereby transferring all risks and benefits.

4.2. Granting Independent Legal Status to Asset-Backed Special Plans

The law repositions the relationship between the special plan and the administrator and grants the special plan the status of a special type of commercial subject. There are obvious differences between the special plan and general commercial subjects, so it is necessary to measure whether the special plan can be granted the status of a legal entity based on the basic elements of the legal subject's right capacity and ability to act. First, the special plan holds independent property to meet the requirement of shaping an independent personality. The property independence of the special plan is mainly manifested in two aspects: on the one hand, all the interests and risks of the underlying assets are transferred to the special purpose institution, making it independent of the sponsor and other participants, and on the other hand, the independent account opened in the name of the special plan creates conditions for the independence of the cash flow of the underlying assets to a certain extent. Therefore, the special purpose plan meets the characteristics of a legal entity with the independent property. Secondly, the independence of property allows the special plan to have independent external responsibility. For example, Article 5 of the Regulations on Asset Securitization Business of Securities Companies and Subsidiaries of Fund Management Companies stipulates that the scope of property of the special plan to be externally liable is limited to its account. At the same time, Article 5 recognizes that the account of the special plan, its assets and funds are independent of the inherent assets of the sponsor, the manager and other participants. From the viewpoint of the elements of civil subjects, the special plan, as a new subject in the financial innovation transaction mechanism, has independent property and the ability to assume external liability, which is in line with the basic elements of civil subjects. Therefore, the legal relationship between the special plan and the administrator should be repositioned in the form of legislation, and the nature and

attribution of the independent assets in the special plan should be determined with a higher level of validity.

4.3. Improve the System of Future Claims Assignment

The system and logic of the assignment of future claims in the commercial financing business should be in line with the requirements of commercial financing for efficiency and security, so it is necessarily different from the assignment of individual claims in traditional civil matters. [11]

The rights of future claims in the process of underlying asset construction are clarified through judicial interpretation. The uncertainty of the time when the transfer of future claims takes effect will blur the time point of the transfer of underlying assets, resulting in the ineffectiveness of the bankruptcy segregation system. According to the traditional civil law theory, the effect of change of rights can only occur after the rights actually exist; however, if we strictly adhere to the logic of this theory of change of rights, the underlying assets are in high risk which is not in line with the actual needs of the transaction. Therefore, for the future claims as the underlying assets, the judicial interpretation should clearly adopt "direct acquisition" which is more suitable for the transaction needs, and the effect of claim assignment will occur after the future claims are actually created, retroactively to the time when the act of disposal is agreed. In this case, if the patentee encounters bankruptcy after the future claim is assigned and before the actual creation of the receivable claim, since the assignment contract has been concluded, the future claim has already belonged to the assignee, and the underlying asset does not have to bear the risk of the patentee's bankruptcy that may occur before the actual creation of the claim, thus ensuring the isolation of risk.

Adding registration of assignment of claims as an element of opposition. In the context of the Civil Code, the notification system of assignment is certainly applicable to the civil claim assignment system. In addition, if the registration of the assignment of claims is added as an antitrust element, it highlights the publicness of the antitrust element and facilitates the debtor and the third party to know the consequences of the assignment of claims. In patent securitization, on the one hand, due to the intangibility, abstractness and complexity of the underlying asset rights, the stability of the underlying asset is the greatest protection for the rights and interests of investors, and the publicity of the antagonistic element is more important. On the other hand, the registration mode provides a more convenient option for the transfer of pooled claims, and the transfer transaction is more efficient and convenient. Therefore, in terms of transaction security and system convenience, increasing the registration of claim assignments as an antagonistic element of claim transfer is meaningful.

5. Conclusion

The "14th Five-Year Plan" for the Protection and Utilization of Intellectual Property Rights once again emphasizes the importance of developing intellectual property finance, which is bound to boost the further development of patent securitization. Currently, China's relevant policies continue to promote the development of patent securitization, but the legal risks in the transfer of underlying assets may hinder the sustainability of its development. It is found that the legal risks involved are mainly attributed to the imperfection of the bankruptcy isolation system. In order to further avoid the risks, the legal standard of true sale in the bankruptcy segregation system should be clarified, the status of independent commercial entity should be granted to the asset-backed special plan and the system of future claim assignment should be improved.

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