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Royalty Securitization

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DIGEST COMMENTARY

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In 1999, rap superstar Eminem released a track presciently titled "Forgot About Dre," in which he says: "[a]nd when your album sales wasn't doing too good, who's the Doctor they told you to go see?" In that context, Eminem was referring to Dr. Dre to suggest that the famous producer could help a struggling rapper make money from his music. In 2017, an investment company is offering investor-fans a new way to make money from music, only they forgot about Eminem.

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The commodification of copyright royalties isn't new, but technological advances like streaming have made it newly lucrative. Streaming transforms music from a one-shot asset (such as an album sale) to one with continuing returns. This might seem like a silver lining for artists who have otherwise been negatively affected by streaming to date, but it probably isn't: digital performance royalties—the royalties paid on streams—are paid to the owner of the copyright in the sound recording, and that owner is usually not the artist.

Investors today have many options when it comes to how and where to invest their money. These opportunities range from the traditional—stock market, real estate, government bonds, small business, and derivatives—to the non-traditional—wine, race cars, fine art, and agriculture. If one can purchase shares of a pig, why not be able to purchase shares of a rap legend? All it takes is a willing rights holder, a willing investor-fan, and the technology to bring the two together.

As an asset, recorded music earns money through sales (including sync licensing), and through royalties collected on public performance rights. Copyrighted recordings earn royalties in two ways: statutorily (for interactive, digital plays), and through privately negotiated licenses (for everything else). To make matters even more interesting, every song is protected by two distinct copyrights —one on the musical composition, and one on the sound recording. It is this latter copyright—and specifically, the digital performance right for sound recordings—that serves as the impetus for this new intersection of law and technology: royalty securitization.

There already exists a private market for artists' (and specific projects') revenue streams. One can invest directly in a film, for example, or in a new band, in hopes of taking a share of the project's or groups' earnings (should there be any). The move from private investment in media assets to their commodification is challenged by high levels of uncertainty inherent in the entertainment industries. One way to diversity that risk is to bundle a large group of such assets together into a securitized "package."

Denver-based company Royalty Exchange touts itself as an "online marketplace for buying and selling royalties," and aims to do exactly that. Since 2011, the company has bundled and auctioned off "packages" of royalty assets for fans and investors. A recently completed auction, for example, advertised an annual return of 8.2% on a package of Grateful Dead royalties: "[i]nvest $135,000 to receive $180,000 in royalty payments generated by the studio and live recordings by the legendary Grateful Dead."

The company recently announced plans to launch a subsidiary venture, Royalty Flow, by means of an IPO in which investors are offered a share in the royalties earned on the company's portfolio of acquired copyrights. The first acquisition is described as 15%-25% of the sound recording rights to superstar rapper Eminem's pre-2013 catalog. Eminem hasn't released any new music since 2013, so for all immediate intents and purposes, this constitutes all of his music.

According to the offering disclosure, Royalty Flow plans to acquire royalty interests in various media assets, and to disburse dividends to their shareholders based on royalties collected from those assets. The company is using Regulation A+ of the JOBS Act in order to sell directly to individual investors, rather than having to go through an accredited investor. The minimum buy-in for the IPO is $2,250 for 150 shares of Class A common stock.

This isn't the first time we've seen an attempt to make money by betting on the future performance of an entertainer. Companies like Fantex began offering "tracking stocks" in athletes like Houston Texans running back Arian Foster back in 2013. But hedging on musicians goes back even further.

The most well-known predecessor to Royalty Flow's IPO is the "Bowie Bond." First in a line of now (in)famous bonds offered by investment banker David Pullman, and rated by Moody's, Standard & Poor's, and Fitch, Bowie Bonds first issued in 1997 as a stock of $55 million in $1000-denominated bonds representing the future earnings of twenty-five David Bowie albums released before 1990.

Unlike Bowie Bonds—which engaged traditional Wall Street apparatus and procedure, and ultimately sold to a single, large,

corporate investor—the appeal of Royalty Flow's IPO hinges on the company's utilization of innovative technological developments to attract lots of smaller, individual investors—not unlike the crowdsourced investment models of Kickstarter and GoFundMe. Advancement in user-friendly online investment software is an obvious boon for Royalty Flow, but it isn't even the most important technological impetus.

What makes RoyaltyFlow's IPO offering so interesting is its utilization of streaming technology to create value for investors in a securitized royalty stream. The evolution and popularity of Internet radio offerings like Pandora, and streaming subscription services like Spotify, have created a new revenue source—not just for content owners, but for investors as well.

Owing to the labyrinthine and piecemeal nature of music licensing in the U.S., digital radio streams—e.g., plays of a song on a platform like Pandora—earn a statutory digital performance royalty every time a song is played. This stands in stark contrast to a play of the same song on terrestrial—i.e., traditional FM/AM—radio, where there is no statutory performance royalty, and where no money is earned on those plays. Added to the Copyright Act as part of the amendment known as the Digital Millennium Copyright Act, digital public performance rights in the age of streaming technology are an entirely new revenue source for rights holders and investors alike.

Streaming now constitutes the largest share of music consumption across all formats (terrestrial radio, digital downloads, CD/vinyl purchases, etc.). IFPI's annual State of the Industry Report 2017 reported a 60.4% year-over-year growth in streaming in 2016. This growth led streaming to comprise a majority of all digital revenues (which themselves make up half of all music revenues, across all formats). Streaming's largest and most popular platform, Spotify, likewise reported a 52% increase in revenues in 2016 and confirmed 140 million users worldwide.

David Bowie didn't have streaming; Bowie and his investors owned a one-shot asset: when you sell an album, you are paid once, no matter how many times the consumer listens to it. But with

streaming, where royalties are pay-per-play, you have an asset with the potential to keep on paying. New IoT technologies like Amazon's Echo, which allows a user to request a playlist while cooking dinner, promise to lead to even more streaming, and even more earnings.

Advancements in data-gathering technology are improving the quality and accuracy of in-app recommendations and targeted ads (think: "if you like Daft Punk, you might also like Fat Boy Slim," or an ad for an upcoming Manchester Orchestra concert being served to Pandora users listening to Brand New), affording even more opportunities for streaming of even more music. And unlike terrestrial radio, the on-demand nature of subscription streaming services allows a listener to dig into the back catalog of a new artist they discover, or to subscribe to a playlist, like Spotify's Time Capsule, designed to harken back to the music popular during the listener's youth. This not only leads to more streaming, but importantly, to greater longevity for a song's revenue stream. All of these developments make music a more valuable asset, and now, a better investment opportunity.

At least that's what RoyaltyFlow is banking on. In a letter from the company's chairman, the IPO is described as perfectly poised to capitalize on "the early stages of a bull market that hasn't been seen since the invention of CDs." If true, this would mark another distinction between RoyaltyFlow's offering and Bowie Bonds: technological *advantage*, instead of technological *disadvantage*.

In the Bowie Bonds offering, Prudential Insurance Company of America ended up purchasing all of the bonds, which started off at an A3 rating, but ended up just a notch above junk status. The reason cited: an unanticipated decline in the sale of recorded music. Indeed, the period between 1997, when the bonds issued, and 2007, when they were set for liquidation, saw the advent of illegal file-sharing services like Napster, the concomitant rise of music piracy, and a dizzying decline in music industry revenues. That didn't stop other artists, like James Brown and Iron Maiden, from trying to emulate Bowie's success; after all, the artist once deemed "Britain's wealthiest rock star" by Rolling Stone magazine pocketed roughly $55 million in exchange for forfeiting only ten

years' worth of royalties (the royalty rights reverted to him upon the bonds' scheduled liquidation in 2007).

This marks yet another significant difference between Bowie Bonds and Royalty Flow's offering: upon completion of Royalty Flow's IPO, Eminem won't pocket anything. That's because unlike David Bowie, Eminem doesn't own his master sound recordings (at least not the 15-25% being offered by his former producers, FBT Productions, as part of the IPO). In fact, Eminem's spokesperson has confirmed that "Eminem is not involved in any deals for the sale of recording royalties and has no connection to this company. The decision to offer the royalty stream for sale or otherwise was made independently by a third party who retains royalties for an early portion of his catalog and Eminem was not consulted."

To be fair, Royalty Flow is careful to use language that falls short of advertising Eminem's buy-in: "we expect that the Eminem *catalog* will benefit from the growth of streaming," and "the opportunity to acquire a piece of an iconic artist's *catalog* is an opportunity too good to pass up" (emphasis added). Still, investor-fans could be forgiven for misunderstanding the opportunity as a chance to support their favorite artist.

Herein lies the rub: Digital performance royalties, and the securitization thereof, offer a new revenue stream for artists—and a symbiotic opportunity for investor-fans to support those artists—but only if the artists own their masters. Otherwise, the proceeds go to the record label, or to the production company, or to Royalty Flow, as the case may be. As Prince famously told Rolling Stone in a 1996 interview: "[i]f you don't own your masters, the master owns you." Most artists don't own their masters, and so cannot benefit from the securitization of their performance royalties. For fans of those artists, investing in performance royalties may bring returns, but not warm fuzzies.

Artists interested in profiting from securitization of their royalties would be well-advised to reclaim their masters as soon as they qualify to do so under the termination clause of the Copyright Act. That clause allows an artist to serve a notice of termination beginning twenty-five years after an initial grant of copyright, with

termination to follow as soon as thirty-five years post-grant. Until then, the options for regaining the benefit of one's masters are limited. Legislators might consider an amendment to the Copyright Act limiting the share of copyright that can be assigned in a sound recording or obtained via work for hire, thereby reserving some portion of the master rights in the original artist. As streaming continues to grow, this small change could be a boon to musicians who have seen their earnings fall precipitously over the last decade.

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