INTELLECTUAL PROPERTY ISSUES AFFECTING A SECURED TRANSACTIONS REGIME

SUBMITTED BY THE COMMERCIAL FINANCE ASSOCIATION[1]

I. INTRODUCTION

This paper is submitted to the United Nations Commission on International Trade Law ("UNCITRAL") by the Commercial Finance Association ("CFA")[2] in connection with UNCITRAL's development of a guide on secured transactions (the "Guide"). The paper seeks to identify issues that frequently arise in financing transactions in which intellectual property plays a role, and offers suggestions as to ways in which these issues may usefully be addressed in the Guide.[3]

A. THE IMPORTANCE OF INTELLECTUAL PROPERTY IN SECURED TRANSACTIONS

With the advent of the "information age" and the rapid pace of technological development, intellectual property such as patents, trademarks, copyrights, customer lists, know-how, and trade secrets represent an increasingly significant component of the value of many companies.

In recent years, there has been a dramatic increase in the number of companies engaged in the business of developing, licensing, distributing, and managing intellectual property. For many of these companies, their principal assets consist of the intellectual property around which their businesses were built. At the same time, companies operating in more traditional arenas are increasingly relying on intellectual property in the operation of their businesses. Manufacturers frequently utilize equipment that requires the use of patented technology for its operation. Distributors often sell goods that derive a significant portion of their value from trademarks affixed to the goods or copyrighted material included in the packaging. In many cases, these intellectual property rights are owned by the companies themselves, but in many other cases they are licensed from third parties.

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1 The Commercial Finance Association wishes to thank the following individuals for their work in the preparation of this paper: Richard M. Kohn, Oscar L. Alcantara, and Jonathan M. Cooper, each a partner in the Chicago law firm of Goldberg, Kohn, Bell, Black, Rosenbloom & Moritz, Ltd., and David W. Morse, a partner in the New York law firm of Otterbourg, Steindler, Houston & Rosen, P.C.

2 CFA is a trade association for financial institutions that provide asset-based commercial financing and factoring to business borrowers. Although most of the members of CFA are headquartered in North America, many are located, or have affiliates or branches, in other countries, or are owned by entities headquartered in other countries. CFA has participated in the development of the Guide as a non-governmental organization. Additional information concerning CFA can be obtained from CFA's web site: www.cfa.com.

3 As of the time this paper is written (August 2004), Working Group VI (the Working Group responsible for preparing the Guide) has determined that the Guide must deal with intellectual property in some respects, and recognizes that, to the extent the Guide already covers general intangibles, intellectual property assets may be affected. The Working Group is continuing to explore what modifications can or should be made to the Guide in light of issues raised herein.

Many companies, including technology companies that currently have resort only to equity investors as a source of capital, as well as more traditional companies that rely increasingly on the use of intellectual property in their businesses, would benefit from access to low-cost secured credit predicated upon the value of their intellectual property rights. However, such secured lending will only be available to the extent that the applicable legal regimes are conducive to the creation and enforcement of security rights in (i) the intellectual property owned by such companies and (ii) commercial goods and other assets owned by such companies that incorporate intellectual property licensed from third parties. In the absence of such a favorable legal environment, these companies will be deprived of an important source of potential financing, and will be placed at a competitive disadvantage in the global marketplace when pitted against companies located in jurisdictions having more favorable secured lending laws.

We suggest that, if the Guide is to respond effectively to the realities of secured financing in today's technology-driven world, it is essential that it acknowledge the importance of, and offer appropriate recommendations concerning, security rights in intellectual property.

B. THE ROLE OF INTELLECTUAL PROPERTY IN SECURED TRANSACTIONS

Intellectual property is typically used as collateral in secured lending transactions in two primary ways (which also provide a useful framework for discussing the issues that might be addressed by the Guide in its treatment of intellectual property).

First, intellectual property rights frequently represent an intrinsic component of the value of other property owned by the debtor,[4] such as goods that have been branded with a registered trademark or that incorporate copyrighted materials in their packaging. Such intellectual property rights (referred to in this paper as "associated intellectual property") may be (i) owned by the debtor or (ii) licensed by the debtor from third parties pursuant to an exclusive or non-exclusive license. In either case, the goods themselves may have little or no value to a lender as collateral unless applicable law would permit the lender to realize upon its security rights in the goods in an efficient and cost-effective manner.

Second, intellectual property often has sufficient independent value so that a debtor is able to use it as collateral for a loan. Examples might be the portfolio of patents owned by a pharmaceutical company or the trademarked name and logo of a well-known chain of retail stores. This is especially true for the growing number of companies in the technology sector. For example, an owner/licensor of computer software might seek to obtain a loan secured by the anticipated streams of royalty payments from its various licenses. In these circumstances, the amount of credit that a lender is willing to extend, and the interest and other compensation that the lender will require, will depend in part on the lender's level of certainty that it will be able to look to the intellectual property as a source for repayment of its loan.

[4] Consistent with the Guide, the term "debtor" is used in this paper to mean the person who owes performance of a loan or other secured obligation. The debtor may or may not be the person who grants the security right to a secured creditor (referred to in the Guide as a "grantor").

In each of these cases, clear and predictable laws are critical to enabling the lender to make this determination. In fashioning such laws, it is important to bear in mind that, in many legal systems, the laws governing intellectual property and the laws governing secured transactions are embodied in separate legal regimes that draw from separate and sometimes conflicting traditions. In some jurisdictions, security rights in certain types of intellectual property are governed by the intellectual property laws, while in other jurisdictions such rights are governed by the secured transactions laws, and in still other jurisdictions they are governed by both sets of laws (often with some uncertainty as to the relationship between the two regimes). Accordingly, when considering the enactment of laws pertaining to intellectual property as it functions in secured transactions, there must be a careful coordination between the laws governing secured transactions and those governing intellectual property rights generally. In addition, because security rights have little or no value to a lender unless the lender is able to realize their economic value in the debtor's insolvency proceeding, there must also be a careful coordination between a jurisdiction's secured transactions and intellectual property regimes, on the one hand, and its insolvency regime, on the other, with the result that the pre-insolvency effectiveness and priority, as well as the economic value, of security rights are respected.[5]

II. ASSOCIATED INTELLECTUAL PROPERTY

A secured lender is often asked to make loans based on the value of a company's inventory or equipment that involves associated intellectual property. As mentioned above, this intellectual property may be either licensed by the company from third parties or owned by the company. The legal considerations applicable to each of these circumstances are quite different.

A. ASSOCIATED INTELLECTUAL PROPERTY LICENSED BY THE DEBTOR FROM THIRD PARTIES

There are many situations in which associated intellectual property is licensed from third parties. For example, a manufacturing company may obtain a license granting it the right to affix a trademarked name, brand, or logo to products that it manufactures, such as "designer" clothing or sunglasses, or sporting goods bearing the name and logo of a sports team, or the right to manufacture stuffed animals based on

[5] The need for a close coordination between secured transactions laws and insolvency laws is a key objective of Guide:

> A security right will also have little or no value to a creditor unless the creditor is able to enforce the security right in a predictable and efficient manner. Thus, the Guide proposes procedures that allow creditors to so enforce their security rights, subject to judicial or other official control, supervision or review when appropriate. The Guide also recommends that there be a close coordination between a State's secured transactions laws and its insolvency laws with a view to respecting the pre-insolvency effectiveness and priority, as well as the economic value, of a security right subject to the appropriate limitations of insolvency law.

A/CN.9/WG.VI/WP.11/Add. 1 (*Chapter 2, Key objectives of an effective and efficient secured transactions regime*), para. 38.

cartoon characters owned by a major film studio. Or a company may obtain a license to use a patented process in connection with the manufacture of its products.[6]

The scope and range of the license from the owner of the associated intellectual property will vary greatly from one situation to another. The license may be exclusive or non-exclusive. It may grant the licensee only the right to use the intellectual property to manufacture the goods, or also the right to sub-license the intellectual property to a third party for purposes of manufacturing the goods. The licensee may also be given the right to sell the goods, either exclusively to the licensor or, more commonly, to the ultimate purchasers. License agreements also vary widely on matters such as (i) quality standards for the goods incorporating the licensed intellectual property, (ii) limitations on the territory in which the goods may be sold, (iii) limitations on channels of distribution for the goods, and (iv) the payment of royalties or other compensation by the licensee to the licensor for the use of the intellectual property.

Lenders confront various unique issues when making loans secured by goods that involve licensed intellectual property. The manner in which these issues are addressed by the applicable jurisdictions will have a profound impact upon the lender's willingness to make such loans.

1. The Lender's Ability to Dispose of Goods Incorporating Licensed Intellectual Property; the "Exhaustion Doctrine"

In each of the examples noted above, if a company seeks to obtain financing based on the value of goods that incorporate associated intellectual property that is licensed from a third party, the secured lender will want to know that, if it ever seeks to enforce its security rights, it will have the right to sell or otherwise dispose of such goods without having to (i) obtain the consent of the licensor, (ii) pay any royalties to the licensor, or (iii) fulfill any other obligations of the licensee under the license agreement.

At the same time, the licensor of the associated intellectual property will not want the actions of the secured lender to have an adverse effect on the value of the licensed intellectual property through the distribution of inferior quality product. The licensor may also have an interest in seeing that the collateral is not sold outside of authorized territories or channels of trade.

It may be possible in some circumstances for a secured lender to negotiate these issues directly with the licensor of the associated intellectual property, either as a condition to funding its loans to the debtor or prior to the enforcement of its security

[6] These situations are to be distinguished from another situation, arising frequently in the context of secured lending, where goods comprising the collateral incorporate a computer program that is "embedded" in the goods and required in order for the goods to function. In the United States, for example, such software is deemed to be part of the goods if it is customarily considered to be part of the goods or if, by becoming an owner of the goods, a person acquires the right to use the software in connection with the goods. On the other hand, if the goods in which the program is embedded consist solely of the medium in which the program is embedded, the software does not comprise part of the goods. Thus, computer programs in themselves are not "goods," but rather are generally considered to be "software." *See* Sections 9-102(44), (75) of the Uniform Commercial Code.

rights in the related goods. For example, the lender may seek an agreement from the licensor granting the lender the right to dispose of inventory so long as the lender complies with certain terms of the license agreement. The licensor may even be willing to agree to purchase the inventory from the lender at an agreed-upon price in the event of a default by the debtor, thereby enabling the licensor to control the manner in which the goods are sold in order to maximize the value of its trademark or other intellectual property. In many license agreements, the licensee is given a period of time (sometimes referred to as a "sell-off period") in which the licensee may sell any goods on hand at the time the license is terminated. In this circumstance, it may well be possible for the lender to obtain the advance permission of the licensor to exercise the licensee's right to sell during such period.[7]

However, often licensors are unwilling to enter into such agreements, and even when they may be willing, the delays and costs associated with seeking these agreements may be prohibitive. In these situations, lenders have to rely upon applicable principles of intellectual property and secured transactions law.

In many jurisdictions, the applicable law on this issue is addressed by a legal concept often referred to as the "exhaustion doctrine." Generally, the licensor of intellectual property has the right to control distribution of goods that incorporate such intellectual property. However, there are limits on such control. Under the exhaustion doctrine, at some point in an intellectual property licensee's product distribution chain, the exclusive right of the licensor to control distribution of the licensed product is deemed to have become "exhausted," and therefore of no further legal effect, with respect to the specific goods being distributed. Once all of the conditions for "exhaustion" under applicable law have been met as to specific goods, subsequent owners of the goods may sell them free from any control or claim by the licensor.

The basic premise of the exhaustion doctrine is that once intellectual property has been fully incorporated into goods in a manner that is consistent with the licensor's quality standards and other requirements, the intellectual property is deemed to be part of the goods. The licensor's interests are protected (because the intellectual property has been processed according to the licensor's requirements and, as a result, there is no need for continued restrictions on the distribution of the goods) and the free flow of commerce is promoted.

The criteria for exhaustion generally differ based on the type of intellectual property involved, and also from jurisdiction to jurisdiction.

For example, under the trademark exhaustion principles in effect in many jurisdictions, if goods are branded with a licensed trademark and the goods have been made in conformity with the terms of the license agreement and the licensee's controls on quality, they would be deemed to be "genuine." Any distribution of such goods should not negatively impact the goodwill associated with the mark. Accordingly, the

[7] It may also be desirable for the lender to have permission from the licensor to complete any work-in-process inventory on hand at the time of the lender's enforcement of its security rights. However, given the personal nature of license agreements, it is highly unlikely that a licensor would grant such permission.

distribution of genuine goods (including a sale or other distribution by a lender in a proceeding to enforce its security rights) should not provide a basis for any objection by the trademark licensor.

Similarly, under copyright exhaustion principles recognized in many jurisdictions, if goods include copies of a work protected by the copyrights owned by a third party (including computer programs or text), and such copies were "lawfully made" according to the law of the appropriate jurisdiction and any applicable agreements protecting the copyright holder, a lender should be able to realize the value of the goods without further interference from the copyright owner. The exhaustion doctrine has been well recognized by the international legal community. Thus, for example, Article 6 of the World Intellectual Property Organization Diplomatic Conference on Certain Copyright and Neighboring Rights Questions, December 20, 1996 acknowledges, in fact, that it is the province of its member nations to determine the circumstances under which copyrights are to be deemed exhausted.

In some jurisdictions, the moment of exhaustion for a copyright can be marked by a product's "first sale": once the copyrighted material has been sold once, it is deemed to be in commerce and can then be resold by each subsequent purchaser of the material or holder of a security right in the material. However, it should be noted that a "first sale" is not the only way to determine that a product was lawfully made, and that a copyright owner's rights may become exhausted even prior to such a transaction. Thus, under the laws of some jurisdictions, the copyright owner's rights can become exhausted as soon as lawfully made copies are possessed by a lawful owner of those copies, even if there has been no "first sale" per se.

Lastly, under patent exhaustion principles, goods that have been made and transferred with the authority of the patent owner are freely transferable to third parties without further interference from the patent owner. As with the trademark and copyright exhaustion principles described above, the specific standards for patent exhaustion will undoubtedly vary from jurisdiction to jurisdiction. However, to the extent that a jurisdiction adopts transparent exhaustion principles with respect to all forms of intellectual property, such laws will undoubtedly increase lenders' confidence in their ability to realize upon collateral within that jurisdiction.

There are often territorial limitations on the exhaustion doctrine, and the subject is a complex one. Most (if not all) jurisdictions recognize the exhaustion doctrine on a "national" level (*i.e.*, once the requirements for exhaustion have been satisfied with respect to particular goods in Country A, the owner of the intellectual property rights loses the exclusive right to control the disposition of those goods in Country A. However, countries are far less uniform on the issue of "international" exhaustion (*i.e.*, whether the owner of the intellectual property rights can object to the importation of goods from Country B into Country A, when the requirements for exhaustion have been satisfied in Country B). On this subject (commonly known as "parallel importation"), there are not only divergent views among countries, but in some cases divergent results within a given country depending upon the type of intellectual property involved.[8]

At the time a lender enforces its security rights in goods with associated intellectual property, license fees may be due and owing to the licensor. That claim for payment, however, should not prevent a lender from realizing on its valid security rights in its collateral where the licensor's intellectual property rights have not been infringed and the concerns of the intellectual property protection laws have been exhausted. If the conditions for exhaustion have been satisfied, the licensor should not be entitled to a royalty payment from the lender or its subsequent purchasers. Thus, the exhaustion doctrine should enable owners to distribute their copies notwithstanding the contractual payment obligations – or for that matter contractual limitations as to channels of distribution or any other matter – contained in the license agreement. If the licensee has in some way breached its contract with the licensor, the licensor may have a contract claim against the licensee; but the licensor is not in privity with the lender, and therefore has no contractual basis for preventing the lender from realizing on its collateral or for making other claims against the lender.

Lending on goods incorporating associated intellectual property in a given jurisdiction would be promoted if the jurisdiction adopted the exhaustion doctrine in its intellectual property law regime, in a formulation that gives secured lenders greater certainty that they may realize on their security rights in the genuine goods, lawfully made copies, and goods made and transferred with the authority of the patent owner, without permission by the licensors of the associated intellectual property. Although the exhaustion doctrine would not eliminate the need for such permissions in all circumstances, it would significantly diminish the instances in which they become necessary.

We do not here attempt to prescribe any specific formulation of the exhaustion doctrine for all states that adopt the Guide or even for any single state. Rather, we suggest here merely that the Guide encourage jurisdictions to examine the existence and application of intellectual property exhaustion principles within their domestic laws, and to consider such principles in light of their effect on inventory financing.

2. THE RISK OF TERMINATION OF THE LICENSE

When a lender extends credit to a debtor based upon security rights in commercial goods having associated intellectual property licensed from a third party, the lender must also consider a number of other issues.

First, the lender must consider the potential impact of any security rights that the licensor may have granted to its own lender in the intellectual property that is the subject of the license. For example, if the licensor's lender sells the intellectual property to a third party in an enforcement proceeding, will that sale extinguish the license agreement, terminating the licensee's rights thereunder (along with the security

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8 *See, e.g.,* 2001 International Association for the Protection of Intellectual Property survey "International Exhaustion of Industrial Property Rights."

rights of the licensee's lender therein) through no fault of the licensee? In some jurisdictions, whether the license will be extinguished will depend, in part, upon whether the license is exclusive or non-exclusive, with the result that an exclusive license is extinguished while a non-exclusive license is not.[9]

A related issue that must be considered by the licensee's lender is the potential impact upon the license of the licensor's insolvency: If the licensor becomes subject to an insolvency proceeding, will the insolvency administrator for the licensor's estate be able to reject or otherwise terminate the license, resulting in the extinguishment of the rights granted to the licensee (along with the rights of the licensee's lender therein)? Some jurisdictions afford protection to the licensee in this situation (and thus to the licensee's lender), while other jurisdictions do not.[10]

The lender must also consider the implications of a possible termination of the license resulting from an insolvency of the licensee. Although the insolvency laws of jurisdictions vary on the issue of whether the commencement of such an insolvency proceeding is, in itself, sufficient to trigger a termination of the licensee's rights (notwithstanding a provision in the license mandating such a termination), the laws of many jurisdictions impose limitations upon the ability of a licensee to assume or assign its rights under the license (especially an exclusive license) in recognition of the personal nature of such licenses. However, a more important consideration for the lender is extent to which such a termination affects the ability of the goods to be sold (either by the lender or the licensee's insolvency administrator).

3. Restrictions on Disclosure of Confidential Information

Another issue to be addressed by the secured lender to the licensee of intellectual property is the effect of a provision in the license agreement restricting the ability of the licensee to disclose to any party, including the lender, confidential information concerning the license. This could pose a particular problem for the lender because the information may be essential to the lender's evaluation of the business of the licensee. However, under the laws of many jurisdictions, this type of clause is deemed to be sufficiently personal to the licensee to require that it be enforced.[11]

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[9] In the United States, for example, the rights of a "licensee in the ordinary course of business" under a non-exclusive license are *not* subject to a security right in the license created by the licensor, even if the licensee knows of the existence of the security interest, so long as the licensee is not aware that the granting of the license violates the rights of the secured party, while this protection is not afforded to a licensee under an exclusive license. See Section 9-321(b) of the Uniform Commercial Code.

[10] Under United States insolvency law, in the event of the licensor's insolvency, if the licensor elects to "reject" (*i.e.,* terminate) a copyright or patent license, the licensee has the choice of either treating the contract as terminated or continuing to use the intellectual property in accordance with the terms of the license agreement. Interestingly, this protection does not apply to licenses of trademarks. *See* Section 365(n) of the United Stated Bankruptcy Code.

[11] This type of clause must be distinguished from another typical clause in a license agreement, not enforceable under the laws of some jurisdictions, that prohibits or restricts the creation by the licensee of security rights in the licensee's interest under the license agreement. However, such contractual restrictions on the creation of security rights are generally more important in the context of loans to a licensor rather than a licensee, and therefore are discussed in a later section of this paper (*see* Section III. E. below).

We suggest that the Guide encourage jurisdictions to protect confidential information and facilitate financing by adopting a rule whereby confidential information provided to a lender in the course of a financing transaction would not be treated as having been disclosed. Such a rule would protect the interests of borrowers in their own confidential information, protect the interests of licensors in confidential information that had been entrusted to licensees, and facilitate the ability of lenders to conduct due diligence for the purpose of evaluating a borrower and its collateral.

B. ASSOCIATED INTELLECTUAL PROPERTY OWNED BY THE DEBTOR

In situations where the associated intellectual property is owned by the debtor, it should be easier for a lender to obtain sufficient rights with respect to it so that issues surrounding the associated intellectual property do not impede the lender's ability to realize on its security rights in the related goods. If, under the applicable legal regime, it is possible to obtain security rights in the associated intellectual property itself, the lender can require that the debtor grant such security rights to the lender as a condition to making the loan. If, on the other hand, the legal regime does not recognize such security rights, it may be possible for the debtor to grant to the lender a license in the associated intellectual property, under which the lender will have sufficient rights to sell or otherwise dispose of the related goods for their full value, without the risk that a claim will be made by the debtor or its insolvency administrator that it is entitled to receive that portion of the proceeds representing the value of the associated intellectual property.[12] In the absence of either security rights in, or a license of, the associated intellectual property, a lender holding security rights in the related goods will be forced to rely upon the exhaustion doctrine[13] in order to sell the goods and apply all of the proceeds thereof to the repayment of its loan.

Recognition of security rights in the associated intellectual property is, of course, the approach that would most effectively promote the availability of secured credit, and for that reason, as well as for the reasons discussed in Section III below, is the approach that we would recommend the Working Group consider adopting for purposes of the Guide.

III. SECURITY RIGHTS IN INTELLECTUAL PROPERTY OWNED BY A DEBTOR

In addition to the examples discussed above, there are many situations in which intellectual property owned by a debtor can serve as collateral for a loan. A company may obtain a secured loan predicated on the value of one or more valuable copyrights, trademarks, or patents (*e.g.*, a lender may make a loan to a publisher or distributor of books based on the value of its entire portfolio of copyrighted material, to a consumer products company based on the value of its trademarked logo, or to a pharmaceutical company based on the value of its patented drugs). A lender may also make a loan to a

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[12] For tax-related or other reasons, some companies transfer their intellectual property to an affiliate company located in another country and license the property back from such affiliate. In this situation, the lender may be able to obtain any necessary security rights or licenses from the affiliate company.

[13] *See* discussion of the "exhaustion doctrine" in Section II. A. 1. above.

debtor based on its anticipated royalty stream resulting from the debtor's license of intellectual property rights to third party licensees.[14] In other situations, the intellectual property may be a key component in the "going concern value" of a debtor and included in a collateral pool comprised of all or substantially all of the debtor's assets, as in the case of an enterprise mortgage or a "blanket lien." Sometimes the intellectual property may be so valuable that it is capable of being appraised for collateral purposes by an independent appraiser, in much the same way that real estate or equipment is appraised for purposes of obtaining a loan.

Among the significant issues that must be addressed when crafting laws on security rights in intellectual property as collateral are the following:

A. THE RECOGNITION OF "TRUE" SECURITY RIGHTS IN INTELLECTUAL PROPERTY

Unfortunately, the laws of some jurisdictions do not recognize the possibility of obtaining security rights, as such, in many important types of intellectual property assets. In some of these jurisdictions, legal fictions have emerged that seek to provide lenders with the functional equivalent of security rights by simulating them in a manner consistent with recognized legal concepts.

One of the most common methods of simulating security rights in intellectual property is a transfer of ownership of the intellectual property to the lender with a license back to the debtor so that the debtor can continue to use the intellectual property in its business. Unfortunately, this approach has a number of adverse side effects that can deter lenders from extending credit based upon the value of the intellectual property.

First, the lender, as the new record owner of the intellectual property, might be required to comply with a wide array of filing obligations in order to maintain the existence of the assigned intellectual property. In the case of a trademark, for example, the lender might be required to file documents periodically attesting to the trademark's continued use. However, the lender may not have first-hand knowledge of such use.

Second, as record owner, the lender may be required to protect or defend the intellectual property in infringement proceedings involving the property. The lender's failure to do so might lead not only to the loss of the intellectual property, but also to liability on the part of the lender.

Third, because the transaction is characterized as a transfer of the intellectual property that divests the transferor of ownership, it is conceptually impossible for the transferor to grant the equivalent of a junior security right in the intellectual property. As a result, the transferor may be unable to utilize the full value of the property as collateral to obtain credit from multiple sources.

In a number of situations, the assignment approach cannot work. For example, some jurisdictions do not recognize an outright assignment of copyrights. Moreover, moral rights (*"droit morale"*), which usually are not assignable or waivable, may operate as a significant limitation on the alienability of intellectual property rights, even

[14] *See* discussion in Section III. D. below.

in jurisdictions where outright assignments are available.[15] In the absence of the availability of true security rights in such intellectual property, these circumstances make it difficult for companies to use certain intellectual property as collateral for loans.

Accordingly, the Guide may wish to recommend recognition of true security rights in intellectual property, in lieu of requiring lenders and debtors to rely on other legal fictions designed to approximate true security rights.

B. UNREGISTERED INTELLECTUAL PROPERTY

Even if the laws of a jurisdiction generally provide for the creation of security rights in certain types of intellectual property, those laws may not permit security rights to be created in intellectual property that has not been registered under the jurisdiction's intellectual property registration system ("unregistered intellectual property"). As a result, the owners of such unregistered intellectual property are unable to use such property as collateral, and a valuable source of potential secured credit is lost.

Unlike most categories of commercial property, intellectual property rights traditionally have been the subject of specialized registration offices within the jurisdiction where protection and enforcement rights are desired (as opposed to the jurisdiction where the property or its owner is located). Some of these offices are chartered to create and grant property rights, while others serve only as registries within which property owners may give notice of their rights to the rest of the world. In either case, business people, intellectual property owners, and the legal community at large have become accustomed to using these registries as a source of information concerning intellectual property rights of companies and individuals.

However, for the reasons discussed below, a wide variety of intellectual property assets that constitute valuable commercial property are not registered by their owners with any registration office. Under most current legal regimes, it is impossible for lenders to obtain security rights in such unregistered intellectual property, and therefore lenders often are unwilling to assign value to such property as collateral.

Creators and producers of works protected by copyright law are generally not required to register their works to enjoy exclusive rights. In addition, there may also be commercial reasons why certain copyrights may not be registered by their owners:

- Software developers may be in the continual process of revising their products and developing new versions and sub-versions of valuable software, thus making registration impractical and costly.
- In the case of consumer products, product packaging and owner's manuals can represent an extremely important component of the

[15] Moral rights, or *droit morale*, generally encompass two rights, articulated somewhat differently from jurisdiction to jurisdiction: (i) the right of integrity (*e.g.*, the right to prevent destruction or mutilation of an original work of art) and (ii) the right of attribution (*e.g.*, an artist's right to have a work correctly attributed to him or her). The right of attribution includes the right to prevent others from claiming authorship of one's work.

products' value. Even in countries where such content is protectable under copyright law, many companies do not rigorously register their rights in such packaging and manuals.

- Internal documents, such as the memoranda, manuals, policies, and records that represent a company's institutional memory and may be essential to its business and operation as a going concern, are rarely registered, even though they may be protected by copyright.
- Blueprints and other technical drawings that keep factory floors operating are frequently overlooked as assets that might be the subject of copyright registration.

In recognition of these commercial realities, States party to the Berne Convention for the Protection of Literary and Artistic Works have agreed that copyright owners need not register their copyright assets in order to own and exploit them.[16]

With respect to patents, concern for the confidentiality of new inventions dictates that not all information regarding applications for patents be searchable by the general public. Moreover, many valuable inventions may simply never become the subject of a fully issued patent. For example, if an otherwise patentable invention is disclosed in a non-confidential manner prior to the filing of a patent application, that disclosure may, in most jurisdictions, result in the failure of a patent application. However, the technology underlying that invention, which may well be considered to be "know-how," may still be extremely valuable to the owner.

With respect to trademarks, some jurisdictions recognize trademark rights from the moment a trademark is used by exposure to the consuming public, whether or not the mark is registered. Even in countries where registration (in contrast to use) is the benchmark of trademark ownership, "well-known" marks that are not registered may still receive some level of protection.

Trade secrets such as customer lists, secret formulae, and marketing plans may, in some instances, be the most valuable intangible assets that a company owns. However, because of obvious concerns for confidentiality, such assets are not typically registered.

Because unregistered intellectual property is frequently valuable despite the fact that it is not registered, it would be extremely beneficial to the owners of these assets if they could use them as collateral to obtain financing. We suggest that the Guide address this issue by recommending one or more ways in which a lender may obtain security rights in all of a debtor's intellectual property, whether or not registered. The most effective way to achieve this result would be for the Guide to endorse the concept that all intellectual property, whether or not registered, be recognized as a class of property in which a security right may be granted.

16 Berne Convention for the Protection of Literary and Artistic Works (Paris Text 1971), Article 5(2).

C. Publicity of Security Rights in Intellectual Property

In order for a secured lender to be able to assess how much it would be able to realize in respect of a debtor's intellectual property in the event the lender enforces its security rights (which directly affects how much credit the lender will be willing to provide based on such intellectual property and the cost of such credit), the lender must be able to ascertain, with a high degree of certainty, the priority that its security rights will have in relation to the rights of other creditors, licensees, assignees, and other third parties. In many countries, this is accomplished through a registration or filing system.

Because intellectual property registries are already widely used throughout the world in intellectual property legal regimes, creditors in these jurisdictions are already accustomed to consulting registries and filing systems to obtain information about, and to establish rights with respect to, intellectual property. Although there would be certain efficiencies associated with using the existing intellectual property registries for filing notices of security rights in intellectual property and establishing the priority of such rights, utilizing existing registries would be problematic for a number of reasons.

First, as noted above, many valuable intellectual property rights that might serve as collateral are not consistently registered, or are customarily not registered at all, in these existing registries, even though such rights may have significant value. As a result, designating such existing registries as the mechanism for publicizing security rights in intellectual property will leave large gaps in the lender's ability to perfect its security rights in all of a debtor's intellectual property.

Second, under the intellectual property registration systems of many jurisdictions, a security right affecting a given item of intellectual property must refer specifically to that item; thus, even if such a system accommodates the registration of security rights, the security rights will not extend to newly-developed or newly-acquired intellectual property unless the lender specifically updates its security documents and filings to apply to it. Because debtors are continually developing new technologies and brands, it is critical that lenders be able to efficiently obtain security rights in such after-acquired intellectual property. However, under such a system it would typically be cost-prohibitive and administratively difficult for a lender to update its security documents and filings with sufficient frequency to assure that, at any given time, its security rights extend to all of a debtor's valuable intellectual property, especially in light of the fact that it may not be known for some time whether the new intellectual property will have commercial value (and therefore value as collateral).

Third, because the registration of intellectual property rights is usually required in the jurisdiction where enforcement of the rights is sought (which may or may not be the jurisdiction in which a company is located), many companies engage in aggressive intellectual property filing practices, often filing applications to register each of their intellectual property assets in multiple jurisdictions. For example, if a trademark owner develops a new flagship brand, it may decide to file trademark applications, all covering the same mark, in many jurisdictions worldwide, including jurisdictions where the owner has no physical assets and jurisdictions where it has no current plans for wide distribution of its products. The same global approach to worldwide filings is often taken with respect to key patents.

If a lender is granted a security right in such a debtor's intellectual property, the lender may feel obliged, under current practices, to file a notice of the security right in each and every office in which the debtor has filed an application. These multiple filings can significantly drive up the costs of intellectual property financings, rendering comprehensive notice filings, practically speaking, impossible.

In response to these issues, the laws of many jurisdictions utilize a separate filing system for publicizing security rights in intellectual property (which often is the same system used for security rights in other types of personal property). Such a system often only requires that filings contain enough detail to put other creditors on notice that the intellectual property is subject to a security right. For example, in some jurisdictions collateral descriptions such as "all of the debtor's existing and after-acquired intellectual property" are sufficient to cover the debtor's entire portfolio of intellectual property, including after-acquired properties.

Under these systems, security rights automatically extend to each new item of intellectual property developed or acquired by the debtor without the need for any additional documentation or action on the part of the lender. Such systems also preserve the confidentiality of the intellectual property collateral because only a notice filing is necessary. Ideally, the system would also permit filings for security rights in unregistered intellectual property, thereby permitting debtors to utilize the value inherent in this property as collateral while avoiding much of the administrative burden and cost associated with registering all of such property.

Finally, the Guide may wish to recommend that security rights in intellectual property be treated in the same manner as security rights in other personal property with respect to priority (*i.e.,* priority determined by order of filing and a super-priority for purchase-money security rights in intellectual property). In this regard, the Guide might consider recommending that, if a creditor has a purchase-money security right in goods (and the identifiable proceeds of such goods), the creditor will also have a purchase-money security right in software acquired for use in connection with such goods (together with the identifiable proceeds of such software).

To further streamline the process, the Guide could recommend that states treat all intellectual property, no matter where or whether registered, as an asset having, as its locus, the domicile of its owner. It has been argued, for example, that, although a trademark owner may seek and obtain registrations in several countries, all of those properties are, nonetheless, intangible assets that have only one location – the domicile of the owner. To publicize the security right, the system could, therefore, require only that the lender file a notice of its security right in a single filing office located in the domicile of the debtor, rather than in multiple intellectual property registries worldwide. Such a system, if widely adopted, would undoubtedly result in far-reaching modifications to existing publicity practices and greatly facilitate a company's ability to obtain financing based upon the value of its portfolio of international intellectual property. Moreover, the simplicity of the system and its certainty would outweigh any burden imposed upon potential buyers or competing creditors to search the company's domicile for potential security rights.

Working Group VI notes that the system of publicity and priority suggested above is largely in place in the Provinces of Canada. Although trademarks may be registered federally, a financing statement filed in the appropriate public notice offices of a borrower's home Province may nonetheless be sufficient to publicize a lender's security right in that registered property and make the security right effective against third parties.

It should be emphasized that the system of publicity and priority suggested above would not purport to affect the validity of, or title to, any item of intellectual property. Rather, such system would only provide a streamlined and effective manner for lenders to publicize their security interests in intellectual property, and not a mechanism for transferring title to such property or an opportunity for lenders to invalidate such properties. Issues such as title to and validity of intellectual property would continue to be the domain of local intellectual property filing offices where applicable. Under the system proposed herein, a lender exercising its security rights in its borrower's registered intellectual property would ultimately be required to file an appropriate assignment in the office that granted or issued the intellectual property rights in order to effectuate any transfer of title from the registrant.

We further note that the system of publicity and priority suggested above would maintain the principle of territoriality that operates at the center of the intellectual property regimes in effect in most jurisdictions. If a borrower has registered its intellectual property rights with the trademark and/or patent offices of several jurisdictions worldwide, the right to exclude other conflicting users of such property rights within the jurisdictions in question is determined solely by local law within each of those jurisdictions. The borrower can, nonetheless, be said to own the various sets of exclusive, territorial rights within its home jurisdiction. Enabling lenders to publicize the existence of their security interests within their borrowers' home jurisdictions recognizes that an intellectual property holder owns its various sets of territorial rights within its home jurisdiction, and, at the same time, does nothing to alter the effect of local intellectual property law within the territories in question.

D. CONTRACTUAL LIMITATIONS ON THE CREATION OF SECURITY RIGHTS

When a debtor licenses the intellectual property that it owns to a third party, the anticipated stream of royalty payments that the debtor expects to receive under the license can represent a valuable source of collateral for a secured loan. However, many license agreements contain a provision prohibiting or restricting the ability of the licensor to grant security rights in its interest under the license, and a lender making a loan secured by such royalty payments must consider the effect of such a clause (*i.e.,* whether the security rights will be valid notwithstanding such contractual limitation, and whether the violation of the contractual restriction will trigger a default under the license agreement).[17]

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[17] Many license agreements also contain a provision prohibiting or restricting the right of the licensee to grant security rights in its interest under the license. However, because the laws of most jurisdictions impose significant restrictions on the ability of a lender to realize the economic value of the licensee's

There is a growing view that, because of their inhibiting effect on secured credit, these clauses should be rendered unenforceable by the secured transactions regime, not only in the context of intellectual property licenses, but also in other contexts in which such clauses arise.[18] Another growing view is that royalty payments owing to the licensor under license agreements should be recognized as receivables, enabling lenders to obtain security interests in such streams of payment without raising the issues that may arise from taking a security interest in the license itself. Serious consideration should be given to taking similar approaches in the Guide.

E. ENFORCEMENT OF SECURITY RIGHTS IN INTELLECTUAL PROPERTY

In order to be willing to provide intellectual property financing in a given jurisdiction, lenders must be convinced that reliable and efficient procedures exist for enforcing their security rights. Although the laws of some countries provide for non-judicial procedures for enforcing such security rights, many countries require that lenders resort to a judicial proceeding, which can be costly and time-consuming. In these jurisdictions, the establishment of efficient non-judicial enforcement procedures, or procedures with light court supervision, would provide an important incentive to secured lenders.

Thus, we suggest that the Guide include recommendations for efficient procedures for enforcing security rights in intellectual property similar to those that the Guide may suggest for other types of collateral, subject to appropriate safeguards for the debtor and other affected third parties.

IV. CONCLUSION

We suggest that, if the Guide is to be truly effective in assisting countries to develop realistic and effective secured transactions regimes, it is important that the Guide acknowledge the increasingly important role played by intellectual property in secured transactions, and offer appropriate recommendations concerning how the issues relating to intellectual property may be addressed in such regimes.

In this regard, the Guide should recommend that jurisdictions strive to coordinate their laws governing secured transactions and those governing intellectual property generally. In addition, both legal regimes should be coordinated with the jurisdiction's insolvency laws to assure that security rights in intellectual property, and in goods incorporating associated intellectual property, are respected.

Because the principal focus of the Guide is on commercial goods, the Guide should address the issues presented when security rights are granted in commercial

interest under a license by selling or otherwise disposing of it in an enforcement proceeding, the lender generally will not look to the licensee's interest as collateral, and will focus more on the lender's rights with respect to the related goods. *See* discussion in Section II above.

[18] *See, e.g.,* Article 9 of the United Nations Convention on the Assignment of Receivables in International Trade (2001), dealing with contractual limitations on the creation of security rights in, and other assignments of, receivables.

goods that involve associated intellectual property. Where the associated intellectual property is licensed by the debtor from third parties, the principal issue to be addressed is the extent to which a lender holding validly created security rights in the goods will be able to sell or otherwise dispose of them in a proceeding to enforce those security rights without the consent of such third parties. In this regard, the Working Group may wish to consider recommending that a jurisdiction adopt an appropriate form of the exhaustion doctrine with respect to various forms of intellectual property. Other issues that should be addressed are (i) the potential impact of any security rights that the licensor may have granted to its own lender in the intellectual property that is the subject of the license, (ii) the potential impact of the insolvency of the licensor, and (iii) the implications of a possible termination of the license resulting from the insolvency of the licensee. Where the associated intellectual property is owned by the debtor or an affiliate of the debtor, these issues may be more readily addressed by a lender if applicable law permits the lender to obtain security rights directly in the associated intellectual property. The Guide should also encourage jurisdictions to protect the interests of borrowers and their licensors in their respective confidential information by treating disclosures of such information in the course of a financing transaction as confidential communications.

The Guide should also address the role of intellectual property owned by a debtor as independent collateral. In connection therewith, the Guide should recommend the recognition of "true" security rights in intellectual property that can attach to all forms of intellectual property, whether or not such property is registered under the applicable intellectual property registration system. A cost-efficient system for giving public notice of such security rights should also be implemented (ideally using the same system that is used for giving public notice of security rights in other forms of personal property). The Guide should also recommend a constructive way to address the issues raised when a license agreement contains a contractual limitation on the granting of security rights. Finally, the Guide should include recommendations for efficient procedures for enforcing security rights in intellectual property similar to those that the Guide may suggest for other types of collateral, subject to appropriate safeguards for the debtor and other affected third parties.