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## INTELLECTUAL PROPERTY FINANCING: AN OVERVIEW

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### I. INTRODUCTION

Intellectual property ('IP') assets are increasing becoming the centrepiece of a global information economy. Recognized IP interests, including copyrights, patents, trademarks, industrial designs and trade secrets, have joined with modern knowledge constructs, including domain names, databases, and personality rights, to create new sources of wealth and opportunity. Since no country has a monopoly on the well-springs of human imagination, the global information economy offers opportunities for sustainable development and improved standards of living for all. A successful information economy, however, requires an integrated legal environment that supports IP rights as well as the commercial practices that allow them to be turned to value.

Traditionally, IP law has focused on recognition and protection of the property right. While essential, this still leaves open another part of the equation: the appropriate rules for managing IP assets in commerce. This latter approach is the province of what is often called "commercial law." Traditional commercial law rules, however, have often evolved to support commerce in tangible commodities and their related trade receivables. These rules are not always well suited to IP. Thus, there is a growing need for a fresh look at both traditional IP law and traditional commercial law to establish a framework for what we might call "commercial IP law." This law would establish modern rules for fair and effective management of IP assets through commercial contracting, secured financing, royalty accounting and asset valuation

The World Intellectual Property Organization ('WIPO') has been a recognized leader in sponsoring efforts to improve the effective management of IP assets. For example, the Patent Law Treaty<sup>1</sup> streamlines procedures filing patent applications, as well as licenses and security interests. The Singapore Treaty on the Law of Trademarks<sup>2</sup> modernizes registration procedures including for trademark licenses. The ICAAN system for resolving domain name disputes encourages efficient practices on the Internet. WIPO has an extensive program to provide assistance to states in optimizing the economic value of IP and integrating it into national development policies.<sup>3</sup> These efforts demonstrate a firm commitment to developing modern legal rules, professional practices, and management systems for the global information economy.

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<sup>1</sup> At <http://www.wipo.int/treaties/en/ip/plt/index.html>.

<sup>2</sup> At <http://www.wipo.int/treaties/en/ip/singapore/>.

<sup>3</sup> See <http://www.wipo.int/ip-development/en/>.

At the same time, other international organizations have addressed commercial practices. For example, the United Nations Commission on International Trade Law (UNCITRAL) has promulgated the U.N. Convention on Contracts for the International Sale of Goods,<sup>4</sup> the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards,<sup>5</sup> and the U.N. Convention on the Use of Electronic Communications in International Contracts<sup>6</sup> which is pending ratification, among other important treaties.

Similarly, the International Institute for the Unification of Private Law (UNIDROIT) has sponsored the Cape Town Convention on International Interests in Mobile Equipment<sup>7</sup> and promulgated a Model Law on Equipment Leasing<sup>8</sup> in 2008. These initiatives propose principles for making and enforcing commercial contracts, primarily with respect to commerce in tangible commodities.

These efforts, while starting from separate sources, are both beginning to converge on the same point: the need to articulate effective principles for commercial dealings in IP. One area where that need is becoming imperative is secured financing. A security right allows a grantor to utilize assets to obtain credit for operating the enterprise. Ideally, a grantor should have effective means to do so for all available assets. As IP becomes an increasing source of asset value in the enterprise, the need to ensure that secured financing law and IP law operate harmoniously is intensifying.

UNCITRAL has been particularly active in assisting states in modernizing their commercial financing practices. In 2005, it completed a Legislative Guide on Insolvency Law,<sup>9</sup> and in 2008 it completed a Legislative Guide on Secured Transactions<sup>10</sup> ('the Guide'). The Guide proposes a comprehensive system to modernize national secured financing laws to meet the demands of a global economy. The Guide, however, is primarily focused on "core commercial assets, such as tangible assets (inventory and equipment) and trade receivables."<sup>11</sup> As such, the law recommended in the Guide does not apply to "in so far as the provisions of the law are inconsistent with national law or international agreements, to which the State is a party, relating to intellectual property."<sup>12</sup> In order to identify these inconsistencies and the means of addressing them, UNCITRAL is preparing an "Annex to the UNCITRAL Legislative Guide on Secured Transactions dealing with security rights in intellectual property"<sup>13</sup> ('the IP Annex'). The IP Annex is, at the time of writing, still under discussion, and a number of issues remain to be resolved. Nonetheless, it has taken many

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<sup>4</sup> At [http://www.uncitral.org/uncitral/en/uncitral\\_texts/sale\\_goods.html](http://www.uncitral.org/uncitral/en/uncitral_texts/sale_goods.html).

<sup>5</sup> At [http://www.uncitral.org/uncitral/en/uncitral\\_texts/arbitration/NYConvention.html](http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention.html).

<sup>6</sup> At [http://www.uncitral.org/uncitral/en/uncitral\\_texts/electronic\\_commerce/2005Convention.html](http://www.uncitral.org/uncitral/en/uncitral_texts/electronic_commerce/2005Convention.html).

<sup>7</sup> At <http://www.unidroit.org/english/conventions/mobile-equipment/main.htm>.

<sup>8</sup> At <http://www.unidroit.org/english/documents/2008/study59a/s-59a-17-e.pdf>

<sup>9</sup> At [http://www.uncitral.org/uncitral/en/uncitral\\_texts/insolvency/2004Guide.html](http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/2004Guide.html)

<sup>10</sup> See UNCITRAL Guide at

[http://www.uncitral.org/uncitral/en/uncitral\\_texts/payments/Guide\\_securedtrans.html](http://www.uncitral.org/uncitral/en/uncitral_texts/payments/Guide_securedtrans.html). The text currently available on-line is subject to final editing.

<sup>11</sup> UNCITRAL Guide, para. 5.

<sup>12</sup> UNCITRAL Guide, Recommendation 4(b).

<sup>13</sup> See IP Annex at

[http://www.uncitral.org/uncitral/en/uncitral\\_texts/payments/annex\\_guide\\_securedtrans.html](http://www.uncitral.org/uncitral/en/uncitral_texts/payments/annex_guide_securedtrans.html). The draft current at the time of writing is A/CN.9/WG.VI/WP.37, with three addenda, under discussion by UNCITRAL Working Group VI (Security Interests) from April 27 to May 1, 2009. UNCITRAL is considering changing the name to the "IP Supplement."

important steps in discussing how traditional IP law can operate effectively with the modern secured financing system proposed in the Guide.

IP law is now at a critical threshold. Many areas of commercial law are undergoing change to adjust to the imperatives of modern commerce. The UNCITRAL Guide is an important initiative in this process. It is supported by the World Bank and International Monetary Fund. IP professionals need to participate in this process of modernization to ensure that commercial law principles apply to intellectual property in conformity with existing legal requirements and established commercial practices.

It is therefore fitting that WIPO, with participation from its colleagues from UNCITRAL, sponsored an Informational Meeting about developments in IP secured financing. The aim of the Meeting was to help provide guidance to participants about current developments in secured financing laws and how they contribute to and benefit from the modernization process. The purpose of this paper is to provide an overview of some of the key concepts and issues in applying secured financing law to IP.

## II. INTELLECTUAL PROPERTY FINANCING EXAMPLES

Images of typical transactions often condition how we think about appropriate legal rules. To understand the issues involved in IP secured financing, it is useful to have some concrete illustrations in mind. Although financing practices can be diverse, for simplicity the following two examples provide useful perspectives.<sup>14</sup> The first one looks at the situation from the standpoint of an initial owner seeking financing to create new IP. The second example looks at the situation from the view of an entity seeking financing for a business that uses IP, much of it licensed from third parties.

### A. Project Financing (Asset-Centric)

The first example involves what is sometimes called “project financing.” This is an “asset-centric” financing in which the organizing variables revolve around specific IP assets and their associated payment streams. Essentially, an IP owner seeks to borrow funds to create and bring to market new IP. The lender looks for security both in the IP to be created and in the royalty payments streams earned from its eventual licensing. A common example of this type of financing is international motion picture production financing:<sup>15</sup>

*Example:* Producer wishes to make a new motion picture. To fund production costs Producer seeks a loan from Bank secured by the copyright in the screenplay and picture when completed and the royalties to be earned from licensing rights in the completed picture. Producer enters into multiple exclusive and non-exclusive licenses with Licensees in various countries who agree to pay fixed “advance guarantees” upon delivery of the completed picture against royalties that will be earned through their exploitation of the picture. Producer, Bank and each Licensee enter into an “acknowledgement and assignment” agreement under which the Licensee acknowledges the prior

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<sup>14</sup> See IP Annex, paras. 33 - 46 for further examples.

<sup>15</sup> This example is drawn from IP Annex, para. 42.

security right of the Bank and the assignment of its royalty payments to Bank, while Bank agrees that if it enforces its security right it will not terminate the license so long as Licensee makes payments and otherwise abides by the license terms. The Bank's loan is based on a percentage of the total of the “advance guarantees” which Producer will then use to cover the production budget for the picture, and Producer will look to royalties that may be earned in excess of the advance guarantees for its profit.

Existing IP law is well suited for this type of financing. It gives creators exclusive rights that allow them to control further uses of their creations, so that asset value arises both in the creation itself and in the array of contractual licenses to use the creation in various times, places and manners. The recognition of “chain of title” for IP means that later transfers take subject to prior transfers, including security rights. Many countries maintain filing systems to facilitate locating prior transfers, and provide priority rules that protect later transferees who take without notice of a prior conflicting transfer. Otherwise, a later transfer can be ended by termination of a prior transfer unless the later transferee obtains an agreement otherwise. This results in a “vertical system” focused on individual items of IP in which “upstream” rights have ongoing impact on “downstream” rights to use the information and collect royalties. It efficiently supports the creation of IP assets that requires substantial investment by allowing financiers to obtain security in the IP and royalty streams arising from its exploitation.

This type of financing is not limited solely to creators. At each step in the chain of title a transferee may finance its own IP interest. In that case, the transferee and its lender finance an interest subject to the claims of prior parties, but superior to the claims of later parties. We might visualize a typical vertical information financing structure as follows:

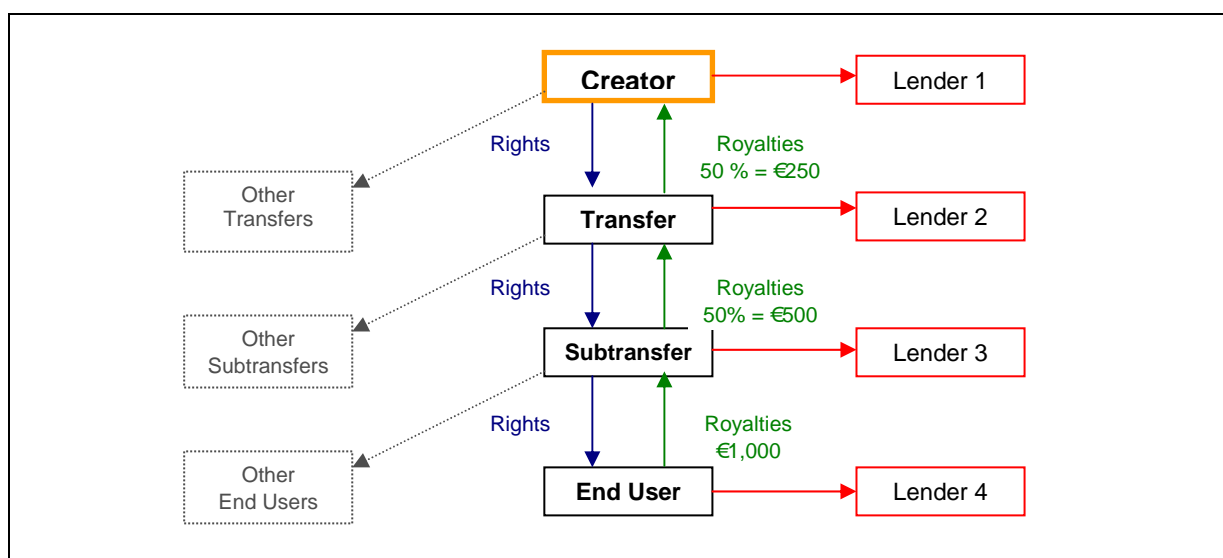


Figure 1: “Asset-Financing” Model

In Figure 1, the IP asset originates with “Creator” and interests fan out in a “tree-like” array of transfers and subtransfers. The ability to make multiple transfers is illustrated by the gray boxes on the left hand side of the tree. The black boxes illustrate a particular “branch” of the tree. The sequence of transfers from Creator to End User is the “chain of title” to that End User. Each step involves a contract in which a transferor grants rights (illustrated by down arrows) in exchange for royalties (illustrated by up arrows). Sometimes, royalties are a

fixed amount, but more commonly they are based on the income derived by a transferee. Thus, in Figure 1, End User pays Subtransferee a royalty of €1,000 for its rights. Subtransferee in turn owes its Transferor a royalty of 50% of its income and so pays 50% of €1,000 = €500 to Transferor and retains €500 for itself. Transferor in turn owes the Creator 50% of Transferor's income and so pays 50% of €500 = €250 to Creator and retains €250 for itself. These payments typically happen continuously throughout the license period.

Figure 1 also illustrates that at each stage a party may grant security to a lender. For example, Creator may grant a security right to Lender 1 to obtain the funds needed to create the IP. Lender 1 then looks to the €250 royalty payment from Transferor (along with all other transfers) to repay its loan. Transferor may grant security in its rights and royalties to Lender 2 to obtain funds to advertise and sublicense the IP, and Lender 2 in turn, looks to royalty payments from Subtransferee to repay its loan. However, absent contrary agreement Lender 2 can only look to Transferor's €250 *net* share of royalty income, not its €500 gross income. This is because Transferor must pay €250 to Creator (and thus to Lender 1) or Creator (or Lender 1) can terminate Transferor's rights and Lender 2 will lose its collateral. Of course, Transferor may, and in practice often does, negotiate with Creator to eliminate termination rights or to treat Creator as an unsecured general creditor. Lender 2, however, benefits from this situation because it knows Lender 3 cannot take the entire €1,000 payment from End User but must, absent a contrary agreement, remit €500 to Transferor to preserve Subtransferee's rights thus ensuring Lender 2 has a source for repayment of its loan.

In the above-mentioned structure, each lender faces four primary risk factors in evaluating whether to make the loan:

- (i) *Due Diligence Risk*: This involves the cost and certainty of conducting due diligence to ensure that the grantor actually owns or controls the specific IP being used as collateral. This requires searching the chain of title back to the original creator. The search needs to be conducted in each relevant country where the IP will be exploited. In so doing, there is risk/benefit analysis whether the costs of search in a particular country justifies the risk of lost income in that country. In any case, to the extent there are readily public registers, especially ones that can be searched on-line, this cost is reduced.
- (ii) *Asset Valuation Risk*: Another risk is whether the value of the IP is appropriate security for the loan. For newly created IP, valuation is particularly difficult.<sup>16</sup> As such a lender typically looks to expected royalty payments to recoup its loan. To the extent that these royalty payments can be represented by fixed sums – the “advance guarantees” in the example – valuation is easier.

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<sup>16</sup> See Arthur DeVany & W. David Wallis, “Bose-Einstein Dynamics and Adaptive Contracting In The Motion Picture Industry”, 106 *The Economic Journal* 1493 (1996): “The hard part about understanding the motion picture industry is coming to grips with the way demand and supply operate. Film audiences make hits or flops ... not by revealing preferences they already have, but by discovering what they like. When they see a movie they like ... they tell their friends about it; reviewers do this too. This information is transmitted to other consumers and demand develops dynamically over time as the audience sequentially discovers and reveals its demand. Supply must adapt sequentially as well, which means there must be a great deal of flexibility in supply arrangements. Pricing must be equally flexible. The crucial factor is just this: nobody knows what will make a hit or when it will happen. When one starts to roll, everything must be geared to adapt successfully to the opportunities it presents.”

- (iii) *Repayment Risk*: A third risk is whether transferees have the ability and willingness to pay their royalties when due. This is especially critical for new IP, whose value is often determined once it is placed into circulation. For example, once a movie is released to the public it is not possible to “un-ring the bell” and undertake a new release if the distributor does not pay. Thus, a Lender often wants to control the licensing practices of its grantor to prevent “improvident licenses” to transferees who are not credit-worthy.<sup>17</sup> Current law facilitates such control by allowing a lender on foreclosure to terminate junior transfers unless the transferee enters into a proper “assignment and acknowledgement” agreement. This gives the lender bargaining power to ensure that the licensee, and as a result the grantor, takes account of the lender and provides adequate assurances of credit-worthiness.
- (iv) *Insolvency Risk*: A final but crucial issue is insolvency risk. A lender wants a cost-effective means to obtain priority over the grantor’s insolvency representative in *this* IP. That is, the lender wants to make sure its security right in the specific IP used as collateral can be separated from other assets of the grantor that may be swept into an insolvency estate. Insolvency law typically provides that a creditor who has taken proper steps under secured transactions law to make its security right effective against third parties – and so prevent a “fraudulent conveyance” – has priority over an insolvency representative. For IP assets, secured transactions often in turn defers to intellectual property law for the proper means for so doing. In many states, a creditor obtains necessary priority by making a timely filing in an available IP register. Where such a registry is unavailable, the results can be more difficult to determine. A key issue in modernizing IP secured financing law is finding effective means to answer this question.

## **B. Working Capital Financing (Enterprise-Centric)**

The second example involves what is sometimes called “cash-flow” or “working-capital” financing. This is “enterprise-centric” financing in that the organizing variables revolve around the on-going business operations of the grantor of the security right as a whole. Essentially, an enterprise that owns or uses IP along with other assets seeks to borrow funds to facilitate the operation of its business. The lender looks for security in (substantially) all of the assets of the enterprise so that in case of default it can easily step in and take over the operation of business and either generate funds to repay its loan or undertake an orderly liquidation. A common example of this type of financing is providing an operating line of credit.<sup>18</sup>

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<sup>17</sup> This can lead to Great Depression-era fraud known as “mortgage milking.” A property owner would obtain a mortgage on a building, then lease out space for high up-front payments but minimal rent. The debtor would take the up-front cash and depart for parts unknown, leaving the hapless creditor with property encumbered with long term, below-market leases. This practice was routinely declared a fraud allowing the foreclosing creditor to dispossess the feckless tenants. See Raymond T. Nimmer & Lorin Brennan, “Modernizing Secured Financing Law For International Information Financing: A Conceptual Framework”, 7 *Houston Bus. & Tax L. J.* 101, 138 (2005). These same practices have not been unknown for intellectual property licenses.

<sup>18</sup> This example is drawn from the IP Annex para. 46.

*Example:* Company is a “fashion house” that manufactures and distributes multiples lines of high-fashion clothing and accessories. It products include trademarked cosmetics and fashion jeans, copyright-protected fabric patterns, and some design patents such as on unique shoe buckles. Many of its products are made and distributed under license from other companies, but Company also has its own line of products which its markets under its own trademarked logo or, in some cases, licenses to others. Company has operations in multiple countries. Company wishes to obtain a €200 million revolving credit facility to provide working capital for its business. Bank is considering extending this facility provided it can obtain a security right in the Company existing and future assets, including its machinery and equipment used for manufacturing, inventory of unsold accessories and apparel, all existing and future IP rights that it owns or licenses from third parties, and all receivables from sales of its products and royalties from licensing of its IP rights.

Secured financing law, especially the system recommended in the UNCITRAL Guide, is particularly suited to facilitate this type of financing. The focus now is on the continuing business operations of the grantor and its shifting stock of assets rather than any one specific asset. As such, this financing uses a security device that can encumber all assets in broadly defined classes of collateral - inventory, accounts, intangibles *etc.* – and that requires minimal monitoring once the initial agreement is struck. The security right is made effective against third parties and obtains priority with a simplified notice filing indexed against the debtor and describing general classes of collateral rather than individual changing items. The security right covers both existing and later acquire assets, alleviating a need to make new filings to maintain effectiveness or priority as assets are acquired by the grantor. This yields a “horizontal” structure in which the relevant inquiry involves the grantor and information about the classes of assets encumbered by the financing. It supports “floating” or “enterprise” liens that smoothly range across all of a grantor’s moveable property in identified categories.

This type of financing can operate for a wide range of businesses. We might visualize a typical horizontal financing structure of this type as follows:

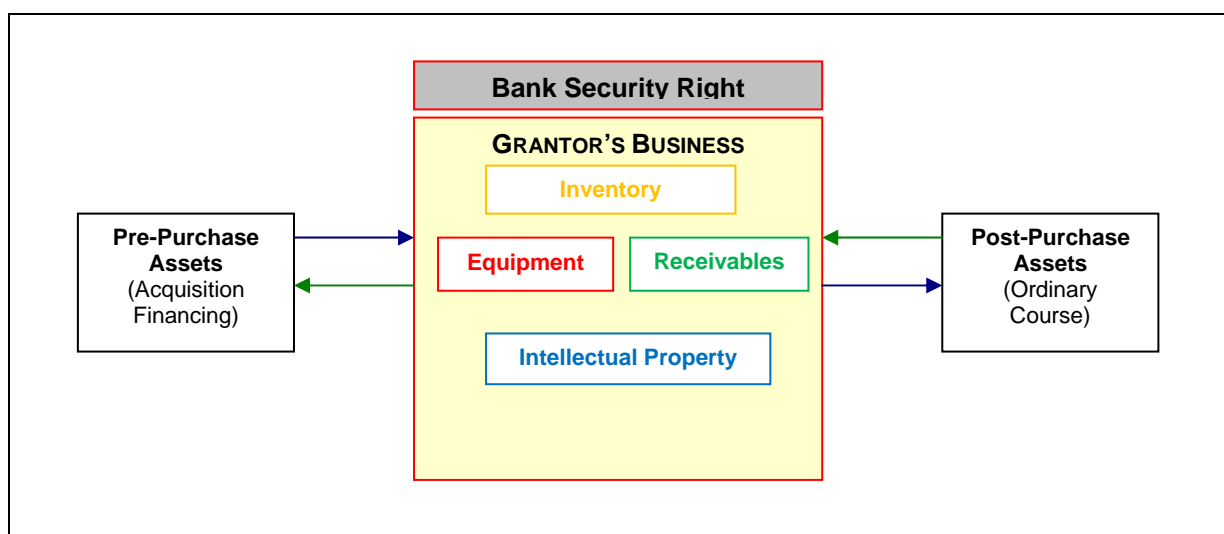


Figure 2: “Enterprise-Centric” Financing

In Figure 2, although individual items of collateral are sometimes important, by and large what matters is the Grantor's current array of assets and receivables as they change over time. Thus, the Bank takes a security right, as illustrated in Figure 2, which covers all of Grantor's assets and receivables. A "future assets" clause allows the security right to be effective automatically in new assets as they come into the business.

This allows the Bank to provide on-going cash flow financing ("revolving credit") based on the Grantor's current assets while still retaining its priority position from its original filing. The security right is also automatically effective in "proceeds" - receivables - from the disposition of assets. In case of default, the Banks forecloses on the Grantor's current assets as they then exist. In this structure, the primary focus is the on-going operations of the debtor, not the particular items of changeable collateral, and the security interest is accordingly filed against the debtor.

This type of financing requires mechanisms to deal with potentially competing claims in assets before they are acquired and after they are disposed. On the pre-purchase side, a business may want to finance the acquisition of specific machinery, but the seller may be reluctant to extend credit if it knows its security right in *that* machinery will become subordinate to a Bank's pre-existing security right.

To solve this, the Guide proposes an "acquisition financing right" – a security right used to finance acquisition of specific tangible goods – which can gain priority over a pre-existing floating lien.<sup>19</sup> Functionally, this works as a substitute for a "retention of title" sale by an equipment seller.<sup>20</sup> On the post-purchase side, a buyer of cosmetics, jeans or other goods would not do so if the buyer thought a foreclosing creditor of the seller could repossess them. The Guide provides that a "buyer in the ordinary course of business" take free of a prior security right against the Grantor,<sup>21</sup> as this would be the usual commercial expectation. In this structure, a lender is also concerned about four risk assessments in evaluating whether to make the loan, but the focus is different:

- (i) *Due Diligence Risk*: As the focus of the lending is now on the grantor as a going concern, a lender first wants to search the general lien records to determine whether there are any liens against the grantor as an enterprise (e.g. "floating" or "enterprise" liens). When it comes to individual items of IP the lender must conduct a risk/benefit analysis whether the costs of searching justifies the risk of lost of use of that particular item. If the IP is a "strategic asset" that generates substantial income, a search may be justified. However, if the intellectual property is incidental to the business – e.g., a site license for a word processing program that is easily replaced – a search may not be necessary.

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<sup>19</sup> See UNCITRAL Guide, Commentary Part IX.

<sup>20</sup> The UNCITRAL Guide, Commentary Part IX paras. 80-83, recognizes that states may continue to recognize such practices in a "non-unitary system" but then proposes functional rules to achieve comparable results.

<sup>21</sup> UNCITRAL Guide, Recommendation 80; also Commentary Part V paras. 67-73.



- (ii) *Asset Valuation Risk*: In this type of transaction, a lender is really looking to the “going concern” value of the enterprise as security rather than individual items of IP. Again, if any IP is a strategic asset whose expected income stream is included in the borrowing base, valuation issues are different. On the other hand, the real value of the IP may be that it allows the grantor to charge a premium for its products, so it is not separately valued. Moreover, since the lender knows that the grantor will often be using the IP under license in its normal business operations, it may be content if the IP is subject to royalty payment obligations, as businesses routinely operate on cash net of payments to suppliers.
- (iii) *Repayment Risk*: In this situation, the lender is primarily looking for repayment from the on-going operations of the grantor. Thus, in case it enforces its security right, it wants to ensure that it can smoothly take over the operation of the business and acquire control of the assets necessary to its operation. This leads to two concerns. First, the lender would like to ensure it can continue using the IP so long as the license terms are honoured. IP law, however, generally provides that licenses are not transferrable without the consent of the licensor, although some states recognize an exception in case of a transfer in conjunction with a transfer of all assets of the enterprise.<sup>22</sup> Second, the lender is concerned about collecting receivables due the grantor to repay its loan. If the grantor owes a portion of these receivables to IP licensors as royalties, there can be tensions between the licensors and the lender as to who has a prior claim to payment.
- (iv) *Insolvency Risk*: In this case a lender also wants a cost-effective means to obtain priority over the grantor’s insolvency representative, but since the financing is based on grantor as an enterprise, the focus is different. In case of insolvency, it is necessary to allocate any value realized from a disposition of the grantor’s assets between the secured and the unsecured creditors. If IP is not included in the secured assets, then there can be disputes about what portion of the value is allocated to the IP and hence available to the unsecured creditors. These disputes can be contentious because of the difficulty in valuing IP. Thus, in this type of financing, the lender wants a security right filed against general classes of collateral in the general security rights register also to be effective against each specific item IP to avoid this allocation dispute. This can also cause tension if IP law requires a specific filing in an IP register against each item of IP.

### C. Contrasting Policies

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<sup>22</sup> See, for example, German Copyright Law (*Urheberrechtsgesetz* 9 Sep. 1965 as amended) Art. 34(3); (“An exploitation right may be transferred without the author’s consent if the transfer is compromised in the sale of the whole of an enterprise or the sale of parts of an enterprise.”); and Spanish Copyright Law (*Texto refundido de la Ley de Propiedad Intelectual*, No. 97, April 22, 1996, as amended) Art. 49: (“No consent shall be necessary where the transfer occurs as a result of the liquidation, or change in ownership, of the corporate transferee.”). All references to national intellectual property laws are to the current English language versions on the WIPO web site. Any error in interpreting of any national law is solely that of the author.

It should be apparent that these two types of financing employ conceptually different frameworks to support structurally different types of financing. In current practice, IP law tends favour the “asset-centric” system, while the secured financing system recommended in the Guide better facilitates the “enterprise-centric” system. Of course, one can utilize each system for the other type of financing, but results can be awkward and more costly. Thus, the system one prefers often depends on the type of financing one is using.

An asset-centric system gives a clear focus for a financing entity whose credit advances are used for the creation and commercialization of a particular IP asset. The system expedites the ability to evaluate risk and security because the priority rules and filing system tracks ownership interests and competing claims by reference to particular IP. As such, a lender need not examine interests relevant to other assets of the grantor, but can focus attention on recovering its loan from the activity involving a particular asset.

In contrast, the enterprise-centric system better supports general business loans by allowing a lender to encumber classes of assets with minimal documentation or monitoring. In this case the system facilitates evaluation of risk and security by dealing with competing claims in reference to the enterprise as a whole. The lender does not need undertake constant filing and releasing individual assets from the security right as they pass through the enterprise because the filing and priority rules already accomplish this result.

Choices are necessary when these financing methods come into contact. This happens when an IP owner who has engaged “vertical” financing then licenses rights to a licensee subject to a pre-existing “horizontal” loan. For example, assume a producer grants a security right in a motion picture copyright to a lender and then licenses rights to a licensee who has a pre-existing security right that covers all existing and later-acquired IP and royalty income. Or assume a trademark owner grants a license to manufacture fashion apparel to a licensee with a pre-existing security right covering all existing and future inventory and IP rights. If the licensee in each case goes into distress, which party has a priority claim to the sublicensing royalties generated by the licensee and inventory it made under the license, the licensor and its lender, or the lender to the licensee?

This requires a decision as to which applicable financing rules - those for the asset or those for the enterprise - take precedence, especially in the priority rules. Should the licensor and its lender who took steps to gain priority under the IP system take precedence over the licensee’s lender who did so under the general secured transactions system? Giving preference to the licensor and its lender ensures that they can get paid and so furthers policies of encouraging the creation and dissemination of new IP. Giving preference to the licensee’s lender fosters policies of encouraging the availability of low cost secured credit to enterprises so that they can generate income from which payments to licensors are made. Similar policy choices are not unknown to IP law, which also seeks to adjust interests between creators and those using their creations. Finding rules that operate appropriately in these cases is a key challenge for IP secured financing law.

### III. CURRENT LEGAL FRAMEWORK

IP secured financing operates at the intersection of two different bodies of law, each with their own policy goals and operational structures. IP law is concerned with encouraging the creation and dissemination of new works of the mind.<sup>23</sup>

Secured financing law is concerned with promoting the availability of secured credit by developing efficient and effective means to utilize all types of moveable assets as collateral.<sup>24</sup> An effective secured financing law should accommodate both policies.

In one sense, IP law is a “specialty” law in that it seeks to promote activity in a specific type of asset, while secured financing law is a “generalist” law in that seeks to promote activity across a range of moveable assets. In another sense, however, IP law is a “primary” law in that it sets for the foundational property rules for recognition and utilization of the asset, while secured financing law is an “accessory” law in the sense that it does not purport to change the property law rules for any collateral but instead provide rules for their utilization in specific commercial practices.<sup>25</sup> Of course, intellectual *property* law must by definition differ from the property law for tangible commodities<sup>26</sup> or IP would cease to exist. Thus, it requires care to reconcile a generalist secured financing law that seeks a common framework for financing all types of moveable assets without changing underlying property law for collateral to the different asset-specific rules of IP law. The IP Annex to the UNCITRAL Guide is working towards this reconciliation. In order to understand how this discussion is evolving, it is useful to recount briefly the development of current approaches in existing secured financing law and in IP law.

#### A. Secured Financing Developments

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<sup>23</sup> WIPO Intellectual Property Handbook: Policy, Law and Use, para. 1.1: “Intellectual property, very broadly, means the legal rights which result from intellectual activity in the industrial, scientific, literary and artistic fields. Countries have laws to protect intellectual property for two main reasons. One is to give statutory expression to the moral and economic rights of creators in their creations and the rights of the public in access to those creations. The second is to promote, as a deliberate act of Government policy, creativity and the dissemination and application of its results and to encourage fair trading which would contribute to economic and social development.” At <http://www.wipo.int/export/sites/www/about-ip/en/iprm/pdf/ch1.pdf>.

<sup>24</sup> UNCITRAL Guide at para. 1: “The purpose of the UNCITRAL Legislative Guide on Secured Transactions ... is to assist States in developing modern secured transaction laws (that is, laws related to transactions creating a proprietary security right in a movable asset) with a view to promoting the availability of secured credit. The Guide is intended to be useful to States that do not currently have efficient and effective secured transactions laws, as well as to States that already have workable laws but wish to review or modernize them or to harmonize or coordinate their laws with the laws of other States.” Also UNCITRAL Guide, Recommendation 1, which states specific policy goals.

<sup>25</sup> IP Annex at para. 10: “The Guide addresses only legal issues unique to secured transactions law as opposed to issues relating to the nature and legal attributes of the asset that is the object of the security right. The latter are the exclusive province of the body of property law that applies to the particular asset (with the partial unique exception of receivables to the extent outright transfers of receivables are also covered in the Guide).”

<sup>26</sup> Understanding the WTO: TRIPS Agreement at para. 2: “Films, music recordings, books, computer software and on-line services are bought and sold because of the information and creativity they contain, not usually because of the plastic, metal or paper used to make them.” At [http://www.wto.org/english/thewto\\_e/whatis\\_e/tif\\_e/agrm7\\_e.htm](http://www.wto.org/english/thewto_e/whatis_e/tif_e/agrm7_e.htm).

This UNCITRAL Guide contains an extensive discussion of the historical approaches to security rights that have developed throughout the world.<sup>27</sup> As such, it is unnecessary to recast the details of that discussion here. However, it is worthwhile to review two broad themes to security rights in moveable property, since they have particular application to IP. Basically, these themes derive from two different conceptual approaches to security rights, one based on incidents of *possession*, the other on incidents of *title*. These in turn lead to varying approaches to security rights in intangibles, in particular IP.

Traditional legal theory divided property into two classes: immovable (or “real”) property involving landed interests; and moveable (or “personal”) property. Moveable property was further divided in tangible property (chattels) and intangible property (contract rights and IP). One may argue that in the modern world, at least *de facto* if not *de jure*, there are now three distinct classes of property – immovable, tangible moveable, and pure intangible - but statutes drafted in earlier times do not say so explicitly.<sup>28</sup> In any case, early financing mechanism for each class of property developed separately. Tangible moveable property (chattels) was financed by possession-based devices, typified by the *pledge*. Under the classical version, a creditor was given physical possession of the collateral, with the debtor retaining a right to recover possession upon repaying the debt. Immoveable property was primarily financing by title-based devices, typified by the *mortgage*. Under this device, outright or conditional title to the property was conveyed to the creditor with the debtor retaining a right to recover full title upon satisfaction of the secured obligation.

A central theme in secured financing law is avoiding a “fraudulent conveyance.” That is, the goal is to avoid extending credit to a borrower based on an apparent ownership of collateral where a third party is the actual but “secret” owner. Put another way, the goal is to encourage commerce by given a preference to the interests of parties who deal in good faith based on the apparent wealth of the counter-party without knowledge of hidden claims. Each financing systems used different means to accomplish these goals. Since immoveable financing was based on incidents of legal title, not physical possession, the law developed public filing systems where parties could file claims about ownership interests in and liens on the property. Such a system was not practical for moveable property, so instead physical possession was the basis for giving third parties notice about claims in the property, a practice dating back to the Roman *pignus*.

The Industrial Revolution required new approaches. It created an ocean of valuable moveable asserts, including railroad rolling stock, industrial equipment and merchant’s wares. However, the pledge proper was inadequate for financing these assets, since it required the creditor take physical possession, while the debtor needed to retain possession in order to run the business. This created a need for *non-possessory* financing of moveable property. Legislatures responded by adapting the pre-existing financing instruments to the new economic imperatives.

One approach was to extend the pledge by creating devices such as the “registered pledge” and “non-possessory pledge.”<sup>29</sup> In order to provide notice of the financing,

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<sup>27</sup> See UNCITRAL Guide, Commentary, I.C. paras. 45-112.

<sup>28</sup> For example, Brazilian Industrial Property Law (Law No. 9,279 of May 14, 1996) Preliminary Provision 5: “For legal effects, industrial property rights are deemed to be moveable property”; and United States Patent Act (Title 35, United States Code) Sec. 261: “Subject to the provisions of this title, patents shall have the attributes of personal property.”

<sup>29</sup> See UNCITRAL Guide, Part I paras. 62-75 (discussing non-possessory financing devices).

legislatures created public filing systems akin to those for immovable property. Filing notice in a general security rights registry was considered a “fictive” change of possession which placed third parties on notice of the financing and so avoided a fraudulent conveyance.

Another approach was to import concepts from immovable property into moveable financing. This led to “title-based” moveable property financing devices, such as the “chattel mortgage” and “retention-of-title” (or “conditional”) sale.<sup>30</sup> Again, legislatures created public filing system to provide notice of the financing. Filing was considered a “constructive” change of possession that satisfied the ancient strictures against fraudulent conveyances.

Both systems reached comparable results by creating a public filing system in which a secured creditor could file notice of the existence of the financing arrangement. However, there were differences between the approaches. In possession based systems, making a filing was considered essential to make the security right effective against third parties at all, whereas in title based systems filing was often necessary only to obtain priority against innocent third parties without knowledge.

As financing practices developed, there was a long-running debate whether the policies against fraudulent conveyances should apply to intangibles. The early focus was on receivables, *i.e.*, intangible contractual payment rights based on goods sold. Should transfers of these intangibles for security be subject to a basic priority rule of “first in time, first in right” (*prior tempore, potior jure*) so that mere assignment of the receivable to the financier was sufficient? Or should the financier be required to take some additional step to provide notice of the financing for it to be effective against third parties? Gradually, the policies in favour of notice were extended to third parties dealing in good faith for specific types of intangibles, such a “holder in due course” of negotiable instruments,<sup>31</sup> and account financiers.<sup>32</sup> These policies often required the financier to take “control” of the intangible, similar to taking “possession” of a tangible asset. Later, filing systems were extended to various types of intangible assets, so that a financier could create an effective security right in, for example, receivables, by filing a notice of the financing in lieu of taking “control.”

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<sup>30</sup> See UNCITRAL Guide, Part I paras. 85-100 (discussing approaches to use of title for security purposes).

<sup>31</sup> See, for example, Grant Gilmore, “The Commercial Doctrine of Good Faith Purchase”, 63 Yale L.J. 1057 (1954) (noting “[t]he triumph of the good faith purchaser has been one of the most dramatic episodes in our legal history.”)

<sup>32</sup> For example, the English court, in *Dearle v. Hall*, 3 Russ. 1 (Ch. 1828), extended the policy to account financing by providing that in case of competing assignments the first one to give notice to account debtor prevailed. American jurisprudence did not follow suit until almost a century later when the U.S. Supreme Court, in *Benedict v. Ratner* 268 U.S. 353 (1924), held that failing to exercise dominion or “control” over assigned accounts so as to provide notice to third parties was a “fraud in law.” See generally Lorin Brennan, “Financing Intellectual Property under Federal Law: A National Imperative”, 23 Hastings Comm/Ent L.J. 195, 216-223 (2001) (discussing history).

With respect to receivables financing, the practice developed of assigning the receivable “with recourse,” meaning that the lender could look to the debtor/assignor in the account debtor defaulted, or “without recourse” meaning that the financier had to look solely to the account debtor. This process of assigning with or without recourse, generally known as “factoring,” often closely resembled a more classical assignment “for security” both in economic effect and mechanics of enforcement. Thus, many systems came to treat an “outright” assignment of receivables as within the secured financing regime.<sup>33</sup> This is the approach in the UNCITRAL Guide.<sup>34</sup>

As a result, in current practice, states rarely adopt totally separate regimes for financing IP as such. Instead, states typically apply their general approach to non-possessory financing to IP. Thus, states that recognize “title-based” financing devices allow them to apply to IP.<sup>35</sup> Similarly, states that use “possession-based” financing devices make them available for IP financing as well.<sup>36</sup> However, in title-based systems, a security transfer (*e.g.* mortgage) is usually considered *effective* against third parties when it is made, but in some countries it loses *priority* against a third party who takes in good faith and without notice. As such, filing in the applicable IP filing system in those countries is not strictly required but is nonetheless encouraged to maintain priority.<sup>37</sup> In contrast, under possession-based systems, filing in an applicable registry system is considered essential to make the security right *effective* against third parties in the first instance.<sup>38</sup> This leads to differences in cases where there is no applicable IP registry, such as for copyrights or trade secrets. In countries using title-based devices, it may still be possible to make an effective security transfer of the IP under a “first in time” priority rule. In countries using possession-based systems, where there is no filing system the IP may be effectively unfinanceable. This matter is discussed further below.

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<sup>33</sup> See UNCITRAL Guide, Part I, paras. 25-29 discussing this development.

<sup>34</sup> See UNCITRAL Guide, Part I, paras. 30-31 discussing impact.

<sup>35</sup> See, for example, Melvin Simensky, Lanning Bryer & Neil J. Wilkof, *Intellectual Property in the Global Marketplace* (2<sup>nd</sup> ed. 1999): at Chapter 31 Australia (IP financing by mortgages and fixed charges), Chapter 41 Germany (by *Sicherungsübereignung* akin to a chattel mortgage), Chapter 45, India (mortgage and assignment with license-back), Chapter 50 Japan (*johto-tampo* akin to assignment with right of redemption), Chapter 51 Korea (security by assignment), and Chapter 61 United Kingdom (mortgages and fixed charges).

<sup>36</sup> See, for example, Melvin Simensky, Lanning Bryer & Neil J. Wilkof, *Intellectual Property Rights in the Global Marketplace* (2<sup>nd</sup> ed. 1999), Chapter 32 Brazil (use of fictitious transfer of possession), Chapter 35 Colombia (use of *prenda sin tenencia* – pledge without dispossession), Chapter 40 France (use of registered pledge), Chapter 48 Italy (discussing possibilities for mortgage or pledge), Chapter 55 Russia (non-possessory pledge).

<sup>37</sup> See, for example, Australian Patent Act s.198, which provides: “(1) A patentee may, subject only to any rights appearing in the Register to be vested in another person, deal with the patent as the absolute owner of it and give good discharges for any consideration for any such dealing. (2) This section does not protect a person who deals with a patentee otherwise than as a purchaser in good faith for value and without notice of any fraud on the part of the patentee. (3) Equities in relation to a patent may be enforced against the patentee, except to the prejudice of a purchaser, in good faith for value”; also Australian Trademarks Act of 1995 s.22 (as amended in 2003). For discussion, see John Swinson, (2002) 14(1) Bond Law Review 9. Note that at the time of writing there is a legislation pending in Australia that could change these rules.

<sup>38</sup> For example, Swedish Patent Act (Act No. 837 of 1967 as amended) Art. 95, provides: “A pledge of a patent or patent application arises by registration of a written contract pledging the property. The application for registration is made with the Patent Authority.” As such, “bona fide acquisition of a patent, or patent application, is not possible under Swedish law.” Melvin Simensky, Lanning Bryer & Neil J. Wilkof, *Intellectual Property in the Global Marketplace* (2<sup>nd</sup> ed. 1999), Chapter 59 p.59.5.

## B. Intellectual Property Developments

IP law tends to rely on a state's general moveable property financing regime for IP financing, only addressing specific issues, if at all, in the IP statutes. However, concepts that apply to the transfer of IP rights can affect security transfers.

The starting point is the international IP conventions. The Patent Law Treaty<sup>39</sup> and Treaty on the International Registration of Audiovisual Works<sup>40</sup> contain rules for filing security interests, but these are more procedural than substantive. However, there are substantive provisions in other treaties. For convenience, it is useful to restrict attention to three primary sources: the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS),<sup>41</sup> the Paris Convention for the Protection of Industrial Property – Stockholm Act (Paris Convention),<sup>42</sup> and the Berne Convention for the Protection of Literary and Artistic Works – Paris Act (Berne Convention).<sup>43</sup> There are three salient points to consider.

The first point is that these conventions recognize that IP interests should be capable of voluntary transfer. Indeed, TRIPS requires that patent and trademark owners be accorded the right to make assignments and licenses under certain conditions.<sup>44</sup> As to copyright, TRIPS incorporates Art. 2(6) of the Berne Convention,<sup>45</sup> which states that its protections “shall operate for the benefit of the author and his successors in title.” This is consistent with the Paris Convention.<sup>46</sup> A security right in many states is conceived of as “collateral” or “conditional” transfer, at least with respect to IP, and so it should fall within these provisions.

The second point is that the international conventions require granting various *exclusive* rights. This has particular importance when it comes to priority rules. They decide as between two conflicting transfers which one is entitled to exercise the exclusive rights. The international conventions do not require any particular priority rule. But they do require consistent results, as otherwise a state will fail to accord *exclusive* rights. Thus, the priority rules for security transfers must harmonize with the rules for transfers generally.

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<sup>39</sup> Patent Law Treaty Art. 14(1)(b)(iii), at <http://www.wipo.int/treaties/en/ip/plt/index.html>.

<sup>40</sup> Film Registry Treaty at [http://www.wipo.int/treaties/en/ip/frt/trtdocs\\_wo004.html](http://www.wipo.int/treaties/en/ip/frt/trtdocs_wo004.html). Art. 3(1) allows registration of “statements concerning audiovisual works and rights in such works.” The discussions leading to the Treaty and available forms indicate the statements can include security rights.

<sup>41</sup> At [http://www.wto.org/english/res\\_e/booksp\\_e/analytic\\_index\\_e/trips\\_e.htm](http://www.wto.org/english/res_e/booksp_e/analytic_index_e/trips_e.htm) (Analytic Guide to TRIPS).

<sup>42</sup> At <http://www.wipo.int/treaties/en/ip/paris/index.html>.

<sup>43</sup> At <http://www.wipo.int/treaties/en/ip/berne/index.html>.

<sup>44</sup> Patents - TRIPS Art. 28.2 provides: “Patent owners shall also have the right to assign, or transfer by succession, the patent and to conclude licensing contracts.” Trademarks - TRIPS Art.21 provides: “Members may determine the conditions on the licensing and assignment of trademarks, it being understood that compulsory licensing of trademarks shall not be permitted and that the owner of a registered trademark shall have the right to assign he trademark with or without the transfer of the business to which the trademark belongs.”

<sup>45</sup> TRIPS Art. 9 provides: “Members shall comply with Articles 1 through 21 of the Berne Convention (1971) (except for Article 6*bis*).”

<sup>46</sup> Paris Convention Art 4(1) provides (emphasis added): “Any person who has duly filed an application for a patent, or for the registration of a utility model, or of an industrial design, or of a trademark, in one of the countries of the Union, *or his successor in title*, shall enjoy, for the purpose of filing in the other countries, a right of priority during the periods hereinafter fixed.”

The acid test comes when a secured creditor transfers the IP on foreclosure. In that case the priority rule must give a consistent answer about who can exercise the exclusive rights used as collateral: the foreclosure sale purchaser from the secured creditor or a purchaser who obtained a conflicting transfer from the grantor of the security right.

The final point is enforcement. TRIPS Article 41 requires member states to ensure that enforcement procedures “permit effective action against any act of infringement of intellectual property rights.” Article 42 says states must make these civil enforcement procedures available to all “right holders.” Also, procedures and formalities for the acquisition and maintenance of IP rights must be “reasonable” under Article 62(1). Finally, while states may create “limitations and exceptions” to the exclusive rights, they must be restricted to special cases which do not conflict with normal exploitation or unreasonably prejudice the legitimate interests of the right holder.<sup>47</sup>

In applying these principles, a seminal issue is whether a secured creditor qualifies as a “right holder.” Secured financing law conceives of a security right as a type of property right in collateral.<sup>48</sup> However, under the *Guide*, a security right does not in itself result in change in *ownership* of the collateral for purposes of secured transactions law.<sup>49</sup> Instead, a secured creditor obtains a special property right to exercise whatever right the grantor has to dispose of collateral in case of enforcement.<sup>50</sup> This is important, because a secured creditor may not want all of the incidents of ownership, *e.g.* an obligation to pay taxes. Sometime it is thought that because a secured creditor is not an owner of collateral for purposes of secured transactions law, it must mean a secured creditor is not an owner for purposes of any other law. The IP Annex<sup>51</sup> specifically dispels this notion as incorrect, and provides:

“[T]he question of who is the owner (or lesser rights holder) with respect to intellectual property and whether the parties may determine it for themselves is a matter of law relating to intellectual property. Under law relating to intellectual property, a secured creditor may be treated as an owner (and may, for example, renew registrations or pursue infringers) or may be entitled to agree with the owner that the secured creditor will become the owner.”

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<sup>47</sup> TRIPS Art. 13 provides: “Members shall confine limitations or exceptions to exclusive rights [for copyrighted works] to certain special cases which do not conflict with a normal exploitation of the work and do not unreasonably prejudice the legitimate interests of the right holder.” TRIPS Art. 17 provides: “Members may provide limited exceptions to the rights conferred by a trademark, such as fair use of descriptive terms, provided that such exceptions take account of the legitimate interests of the owner of the trademark and of third parties.” TRIPS Art. 30 provides: “Members may provide limited exceptions to the exclusive rights conferred by a patent, provided that such exceptions do not unreasonably conflict with a normal exploitation of the patent and do not unreasonably prejudice the legitimate interests of the patent owner, taking account of the legitimate interests of third parties.”

<sup>48</sup> UNCITRAL Guide, Part I para. 88 provides: “‘Security right’ means a property right in a movable asset that is created by agreement and secures payment or other performance of an obligation, regardless of whether the parties have denominated it as a security right.”

<sup>49</sup> IP Annex para. 34 provides: “For the purposes of secured transactions law under the Guide, the creation of a security right does not change the owner (or lesser rights holder) of the encumbered intellectual property (in other words, who is the owner or rights holder) and the secured creditor does not become an owner (or lesser rights holder) on the sole ground that it acquired a security right in intellectual property.”

<sup>50</sup> See IP Annex para. 35.

<sup>51</sup> See IP Annex para. 36.



What this means in simple terms is “to each his own.” “Ownership” is really a label that reflects a legal conclusion about the ability of a party to exercise incidents of a property right.<sup>52</sup> Under the Guide, each body of law deals with these incidents for its own purposes. Thus, for purposes of determining rights and obligations of the parties under a security right, secured transactions law, as reflected in the Guide, does not rely on whether or not a secured creditor is classified as an “owner.” That is, the rights and obligations of the parties *for purposes of secured financing law under the Guide* exist independently of whether a party is an “owner” of the collateral under other property law. However, for purposes of IP law, such as legal authorization (“standing”) to deal with governmental authorities, to make transfers or to pursue infringers, whether a secured creditor qualifies as an “owner” is left to IP law. Simply put, the Guide does not purport to decide whether a secured creditor qualifies as an “owner” (or “right holder”) for resolving issues specific to IP law.

Of course, that does not mean the issue disappears. To the contrary, the status of a secured creditor under IP law is of some importance. In this regard, a secured creditor should qualify as a “right holder” under the international conventions, especially TRIPS. This follows from three observations. First, TRIPS protections in Article 42 apply to “right holders” a term that is broader than “owner.”<sup>53</sup> The term includes parties with legal standing to assert rights,<sup>54</sup> and states often allow secured creditors to take legal action against infringers to protect the value of their IP collateral.<sup>55</sup> Second, the Guide, consistent with national laws, treats a security right as a *property* right which can take *priority* over interests. If a secured creditor were not a “right holder” this would mean secured financing law is creating a new *property* regime in IP that allows a secured creditor to exercise the exclusive rights of its grantor/rights holder on foreclosure with priority over right holders without the secured creditor itself being a right holder. This would supersede the system of exclusive property rights accorded to right holders in TRIPS and other international conventions. Finally, if a secured creditor were not a “right holder” a state could deny national treatment and minimum rights, such as by declaring that only national banks but not foreign banks may take security rights in IP, or that national banks may peruse infringers but foreign banks may not. This would not only impair international secured lending, but would also undermine the international system for IP protection.

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<sup>52</sup> See Melvin Simensky, Lanning Bryer & Neil J. Wilkof, *Intellectual Property in the Global Marketplace* (2<sup>nd</sup> ed. 1999), Chapter 35 Colombia (noting the Colombian Constitutional Court has declared intellectual property a *sui generis* type of property because it has the essential elements of property: *jus-abutendi*, *jus-utendi* and *jus fruendui*).

<sup>53</sup> Appellate Body Report, *United States – Section 211 Appropriations Act*, para. 217 states: “We agree with the Panel that the term ‘right holders’ as used in Article 42 is not limited to persons who have been established as owners of trademarks. Where the TRIPS Agreement confers rights exclusively on ‘owners’ of a right, it does so in express terms, such as in Article 16.1, which refers to the ‘owner of a registered trademark’. By contrast, the term ‘right holders’ within the meaning of Article 42 also includes persons who claim to have legal standing to assert rights.” At [http://www.wto.org/english/res\\_e/booksp\\_e/analytic\\_index\\_e/trips\\_03\\_e.htm#article42](http://www.wto.org/english/res_e/booksp_e/analytic_index_e/trips_03_e.htm#article42).

<sup>54</sup> TRIPS Art. 42, fn 11 provides: “For the purpose of this Part, the term “right holder” includes federations and associations having legal standing to assert such rights.”

<sup>55</sup> See, for example, Mexican Industrial Property Law (*Ley de la Propiedad Industrial* of June 25, 1991, as amended).

A related question is whether royalties from IP transfers are also within the ambit of “IP law.” The Guide treats rights to receive payment of royalties arising from a transfer as proceeds in the form of receivables.<sup>56</sup> These royalty payment streams can also be financed as separate collateral.<sup>57</sup> The Guide does not decide the treatment of royalties for purposes of IP law.<sup>58</sup> However, it also seems clear that a right to royalties could well fall within the coverage of IP law as a basic incident of IP rights. As the World Trade Organization notes<sup>59</sup>: “Creators can be given the right to prevent others from using their inventions, designs or other creations — and to use that right to negotiate payment in return for others using them. These are ‘intellectual property rights.’” Indeed, TRIPS arbitral decisions have treated royalties as an essential benefit arising from the grant of IP rights,<sup>60</sup> so that the ability to collect royalties is considered an essential part of the economic rights accorded to IP owners.<sup>61</sup> National IP statutes also recognize the rights to collect royalties as an essential component of IP rights,<sup>62</sup> as do national courts.<sup>63</sup>

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<sup>56</sup> IP Annex, Add. 1 para. 45 provides: “[T]he Guide treats rights to receive payment of royalties arising from the transfer or licence of intellectual property as proceeds of intellectual property in the form of receivables”.

<sup>57</sup> IP Annex, para. 16 provides. “For purposes of secured transactions law, the intellectual property right itself is distinct from the income streams that flow from it, such as the income received from the exercise of broadcasting rights.”

<sup>58</sup> IP Annex, Add. 1. para. 47 provides: “Furthermore, it is important to note that the treatment of the right to receive payment of royalties for the purposes of secured transactions law as proceeds of intellectual property in the form of receivables does not affect the different treatment of this right to royalties under law relating to intellectual property.”

<sup>59</sup> Understanding the WTO: TRIPS Agreement, at [http://www.wto.org/english/thewto\\_e/whatis\\_e/tif\\_e/agrm7\\_e.htm](http://www.wto.org/english/thewto_e/whatis_e/tif_e/agrm7_e.htm).

<sup>60</sup> Award of the Arbitrators, *United States - Section 110(5) of the U.S. Copyright Act* WT/DS160/ARB25 para. 3.17 (January 15, 2001) states: “If it is assumed, then, that copyright holders exploit their exclusive rights by granting licences for the use of their works, one of the benefits which arise from those rights consists of the licensing royalties which right holders would receive. Thus, exclusive [broadcasting] rights such as those set forth in Articles 11bis (1) (iii) and 11(1)(ii) [of the Berne Convention] will normally translate into economic benefits for copyright holders.” Copy available at [http://www.wto.org/english/tratop\\_e/dispu\\_e/dispu\\_settlement\\_cbt\\_e/a1s1p1\\_e.htm](http://www.wto.org/english/tratop_e/dispu_e/dispu_settlement_cbt_e/a1s1p1_e.htm)

<sup>61</sup> See Award of the Arbitrator, *United States - Continued Dumping And Subsidy Offset Act Of 2000*, WT/DS217/ARB/BRA, and Para. 3.37 - 3.39 (August 31, 2004) (noting and applying principle).

<sup>62</sup> For example, Brazilian Copyright Law (Law No. 9610 of February 19, 1998 on Copyright and Neighbouring Rights as amended) Art. 38 provides: “The author has the irrevocable and inalienable right to collect a minimum of five percent of any gain in value that may be achieved in each resale of an original work or art or manuscript that may be disposed of.” The Canadian Copyright Act (R.S. 1985 c. C-42) s.29.6 (5) provides: “Where the copyright owner authorizes fixation or reproduction to be retained after thirty days, the programming undertaking must pay an applicable royalty.” The German Copyright Law (*Urheberrechtsgesetz* 9 Sep. 1965 as amended) Art. 27(1) provides: “If the author has granted to the producer of an audio recording or a film the rental right with regard to a video or audio recording, the hirer shall nevertheless pay an equitable remuneration to the author for the rental. The claim to equitable remuneration cannot be waived. It can only be assigned in advance to a collecting society.” The Mexican Copyright Act (*Ley Federal del Derecho de Autor* of March 24, 1997, as amended) Art.31 provides: “Any transfer of economic rights shall provide for the grant to the author or to thy owner of the economic rights, as the case may be, of a proportional share in the proceeds from the exploitation concerned, or a predetermined, fixed amount of remuneration. That right shall be unrenounceable.”

<sup>63</sup> For example, European Court of Justice, Judgment of 18 Mar. 1980, Case 62/79, *Procureur du Roi v. Marc Debauxe et al. (Coditel I)* [1980] E.C.R. 881 para. 14 states: “The right of a copyright owner and his assigns to require fees for any showing of a film is part of the essential function of copyright in this type of literary and artistic work”. See also United States Supreme Court, *Automatic Radio Co.*

As such, royalties, even if they can be financed separately from IP rights, are still within the scope of IP. This means that national treatment and related treaty obligations should also apply to financing of IP royalties.

#### **IV. ISSUES FOR INTELLECTUAL PROPERTY SECURED FINANCING**

The discussions for the IP Annex have demonstrated that states which wish to implement the secured financing regime recommended in the UNCITRAL Guide must face several issues when applying it to IP. At the time of this writing, those discussions are still continuing, therefore doubtless additional insights will occur. Nonetheless, it is useful to identify some of the issues that have come to light in the process.

##### **A. How Should a State Enable IP Secured Financing?**

The starting point is considering how a state should enable IP secured financing in the first place. This raises issues about how a state should transit from its current system of secured financing to the approach recommended in the Guide for financing practices in general, and then how that system should apply to IP in particular.

###### **1. Secured Financing Perspective**

In current practice, many countries recognize multiple financing devices with each one suited to a particular type of property or financing transaction. The advantage of such an approach is that it uses devices tailored to specific purposes. But there are disadvantages. It places a premium on specialized knowledge of the available financing devices, since use of the wrong device can often be fatal to a lender's priority.<sup>64</sup> It also makes "cash flow" financing that covers a range of different collateral used by the enterprise more costly.

Instead of this system of multiple devices, the UNCITRAL Guide proposes an "integrated and functional" approach in which a single universal system applies to all financing transactions in moveable property.<sup>65</sup> As the Commentary explains:<sup>66</sup>

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[Footnote continued from previous page]

*v. Hazeltine*, 339 U.S. 827, 833 (1949), which states: "The right to a patent includes the right to market the use of the patent at a reasonable return."

<sup>64</sup> A noted American scholar described the process thus: "Ultimately, the financial community had its way and personal property, both tangible and intangible, became available for security without a change of possession. The process, however, took the best part of a century, during which the law of personal property security transactions came to resemble the obscure wood in which Dante once discovered the gates of hell." Grant Gilmore, *Security Interests in Intellectual Property* (1964), Chapter 2.2, p. 27.

<sup>65</sup> UNCITRAL Guide, Recommendation 8 provides: "The law should adopt a functional approach, under which it covers all rights in movable assets that are created by agreement and secure the payment or other performance of an obligation, regardless of the form of the transaction or the terminology used by the parties ..."

<sup>66</sup> UNCITRAL Guide, Commentary Part I para. 56.

“Many States have secured transactions regimes that permit grantors (especially companies) to offer security to creditors based upon all (or substantially all) of their assets. Nonetheless, in many of these States different legislative regimes govern different types of asset. Moreover, in many of these States different legislative regimes govern different types of transaction (pledges, fiduciary transfers, hypothecs and so on). Finally, in many States, the rights of sellers are treated differently from the rights of other providers of credit and are often not considered to be security rights at all. In contrast to this diversity, the Guide adopts what might be characterized as an integrated and functional approach. It takes the position that, to the maximum extent possible, all transactions that create a right in any type of asset meant to secure the performance of an obligation (that is, to fulfil security functions) should be considered to be a secured transaction and regulated by the same rules or, at least, by the same principles.”

Of course, no system can be strictly universal in the sense that it allows only one type of financing transaction. Different assets and varying financial arrangements need specific rules. This was the reason diverse devices evolved in the first place. The “integrated and functional” system in the Guide accommodates these needs by making adjustments in individual rules to accommodate specific types of assets and transactions. Thus, the Guide still allows different types of financing, but does so by providing functional rules for specific situations rather than by adopting separate financing devices. To understand the system in the Guide, it is therefore helpful to review briefly the basic system without dwelling on specific exceptions.

Under the Guide, there are five general principles to consider: the means for *creation* of the security right; the manner of obtaining *effectiveness* against third parties; the resulting *priority* against competing claimants; the methods for *enforcement* of the security right; and the applicable *choice-of-law* rules in multi-state transactions.

In basic terms, under the Guide parties can use one instrument, a “security agreement,” to create a security right in all types of moveable property.<sup>67</sup> The parties are the secured creditor and the “grantor” of the security right, who may be different from the “debtor” on the obligation to the creditor.<sup>68</sup> For intangible assets, the security agreement must be signed by the parties.<sup>69</sup> It can cover both existing and later acquired (“future”) assets of the grantor.<sup>70</sup> Once the security right is created it becomes enforceable between the parties themselves.<sup>71</sup>

However, to make the security right effective against third parties requires an additional step. For intangibles, this typically requires filing a notice against the grantor that generally

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<sup>67</sup> UNCITRAL Guide, Recommendation 13.

<sup>68</sup> UNCITRAL Guide, Commentary Part II, para. 37: “In most cases, the grantor of the security right will also be the debtor of the obligation that is being secured, but this need not necessarily be the case. Many States permit a third person to create a security right in its assets for the benefit of the debtor. For example, parents may grant a security right in their assets in order to secure an obligation contracted for by their child...”

<sup>69</sup> UNCITRAL Guide, Recommendation 15. The security agreement may be oral only if accompanied by the secured creditor’s possession of the encumbered asset, which would not be possible for intangibles.

<sup>70</sup> UNCITRAL Guide, Recommendation 13.

<sup>71</sup> UNCITRAL Guide, Recommendation 13.

describes the collateral in a general security rights registry proposed in the Guide.<sup>72</sup> This filing gives the secured creditor priority against various competing claimants, for example, other purchasers of the collateral and creditors of the grantor, including any insolvency representative.<sup>73</sup> In case of default, the secured creditor may enforce the security right either by resort to legal procedures or by an extrajudicial foreclosure under which the secured creditor exercises the grantor's right to dispose of the collateral by transferring it to third parties.<sup>74</sup> Finally, in case of multi-state transactions, the Guide proposes that the "law of the location of the grantor" should determine issues of creation, effectiveness, priority and enforcement of a security right in intangibles.<sup>75</sup>

The financing system in the Guide greatly facilitates "all-asset" financing that cover all moveable property of the grantor now existing or later acquired. In this regard, it builds on earlier devices such as the "floating charge" or "enterprise lien."<sup>76</sup> The Guide contains special adjustments to the priority rules to allow suppliers of equipment and tangible goods to "cut-through" a pre-existing security right against a buyer by using an "acquisition-financing" device.<sup>77</sup> Also, buyers and lessees "in the ordinary course of business" can "take free" of the security right as this is the usual commercial expectation for tangible property.<sup>78</sup> However, a security right can remain effective in proceeds, such as receivables, from the sale or lease of collateral, with the same priority.<sup>79</sup>

## 2. Intellectual property applications

As the discussions regarding the IP Annex have brought to light, IP laws often have their own particular rules that impact secured financing. As the Guide candidly acknowledges; "The primary focus of the Guide is on core commercial assets, such as tangible assets (inventory and equipment) and trade receivables."<sup>80</sup> Thus, it is necessary to evaluate how the Guide's "integrated and functional" system should apply to the different legal and commercial practices applicable to IP assets and their royalty income streams.

The Guide's basic approach to IP is deference. That is, while the Guide recommends in principle applying its system to IP, in practice it defers to IP law in case of conflict. The main provision is Recommendation 4(b):

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<sup>72</sup> UNCITRAL Guide, Recommendation 32. As discussed below, under Recommendation 38 for intellectual property subject to a specialized register, an alternative is filing in the register.

<sup>73</sup> UNCITRAL Guide, Recommendation 76 (priority among competing claimants) and Commentary, Introduction para. 88 (containing definition of "competing claimant").

<sup>74</sup> UNCITRAL Guide, Recommendation 142.

<sup>75</sup> UNCITRAL Guide, Recommendation 208.

<sup>76</sup> See UNCITRAL Guide, Commentary Part II, para. 64-67.

<sup>77</sup> See UNCITRAL Guide, Commentary Part IX. The Guide allows states to continue a "non-unitary" which continues retention-of-title transactions but provides functional rules that yield results comparable to the "unitary" approach that generally treats acquisition financing as an exception to the effectiveness and priority rules.

<sup>78</sup> See UNCITRAL Guide, Recommendations 81(a) & (b). The proposal in Recommendation 81(c) that the same "ordinary course" exception should apply to non-exclusive licenses of intangibles appears inconsistent with intellectual property law. As a result, the current draft of the IP Annex suggests that the "ordinary course" exception should not apply it to non-exclusive IP licenses.

<sup>79</sup> UNCITRAL Guide, Recommendation 100.

<sup>80</sup> UNCITRAL Guide, Commentary Part I para. 5.

“[T]he law should not apply to: (b) Intellectual property, in so far as the provisions of the law are inconsistent with national law or international agreements, to which the State is a party, relating to intellectual property.”

Thus, “as the recommendations have not been prepared with intellectual property issues in mind, in the case of any inconsistencies with national law or international agreements to which a State is a party, the Guide would not apply (see recommendation 4, subparagraph (b)).”<sup>81</sup> However, Recommendation 4(b) is not a total exclusion of IP from the Guide. Rather, it only recommends the Guide should not apply to the extent “inconsistent with national law or international law, to which the State is a party, relating to intellectual property.” Thus, the Guide suggests that states “analyze each circumstance on an issue-by-issue basis [giving] proper regard both to establishing an efficient secured transactions regime and to ensuring the protection and exercise of intellectual property rights in accordance with international conventions and national laws.”<sup>82</sup>

In applying Recommendation 4(b), the Guide does not purport to identify all assets that a state might consider to be “intellectual property.” Rather, it defines “intellectual property” as “copyrights, trademarks, patents, service marks, trade secrets and designs and any other asset considered to be IP under the domestic law of the enacting State or under an international agreement to which the enacting State is a party.”<sup>83</sup> Thus, while the Guide recognizes basic types of IP, it also includes other assets which states may include in its IP law, such as databases or rights of equitable remuneration. As the IP Annex affirms, “the Guide treats as “intellectual property,” for the purposes of the Guide, whatever an enacting State considers to be IP in compliance with its international obligations.”<sup>84</sup> Also, the “law relating to intellectual property” is not limited solely to statutory enactments but includes “both statutory and non-statutory law.”<sup>85</sup> As the IP Annex also explains, the expression “is broader than IP law (dealing, for example, with patents, trademarks or copyrights) but narrower than general contract or property law. In particular, the expression “law relating to intellectual property” means law that governs specifically security rights in IP, and not law that generally governs security rights in various types of asset and that may happen to govern security rights in IP.”<sup>86</sup> For example, if a state adopted a law that applies specifically to pledges of rights in software, that would be a “law relating to intellectual property.”<sup>87</sup> Thus, in applying Recommendation 4(b), states will need to make a decision on whether particular assets are included in its definition of “intellectual property” and whether those assets are subject to a “law relating to intellectual property” which is “inconsistent” with the Guide.

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<sup>81</sup> UNCITRAL Guide, Commentary, Part I para. 33.

<sup>82</sup> UNCITRAL Guide, Commentary Part I para. 36.

<sup>83</sup> UNCITRAL Guide, Commentary Part I para. 88.

<sup>84</sup> IP Annex, para. 15.

<sup>85</sup> UNCITRAL Guide, Commentary Part I para. 88.

<sup>86</sup> IP Annex, para. 17.

<sup>87</sup> IP Annex, para. 17. See France, Law L132-34 (inserted by Act. No. 94-361 of 10 May 1994, art. 7 Official Journal of 11 May 1994) adding law on “Pledging of the Right to Exploit Software.”

IP laws tend to be asset specific in the sense that there are often different statutory schemes for patents, trademarks, industrial designs, copyrights, neighbouring rights, databases, trade secrets and the like. In many states, the individual statutes refer to security rights (e.g. “pledges”) sometimes with different results for different types of IP. This raises the initial question whether there should be a different financing scheme for each separate type of IP, or at least a separate financing scheme that just applies to all types of IP. The notion of using separate financing systems just for specific types of IP is rare. Instead, the usual approach is to apply the state’s general law for secured financing of intangibles to IP, but with specific adjustments as needed to accommodate IP. This is the approach in the Guide: a single unified system with functional adjustments as needed for specific cases. This is one reason the Guide invites an “issue by issue” analysis of how its recommendations should apply to IP. Otherwise, if a state adopted the Guide but excluded IP entirely, it would be necessary to craft an entirely new law just for IP secured financing, which hardly seems efficient. As such, states enacting the Guide should instead examine issue-by-issue how it operates for each type of IP with respect to each area of creation, effectiveness, priority, enforcement and choice-of law.

As the Guide notes, “two of the most essential concepts of successful secured transactions laws [are] the concepts of effectiveness against third parties and priority.”<sup>88</sup> These are two particular issues on which many IP statutes often have specific provisions. However, those existing provisions were enacted in light of the state’s current approach to secured financing. Thus, in addressing how the Guide applies to existing IP, it will also be necessary to understand the state’s current approach to secured financing, how the Guide changes that approach, and how IP statutes crafted for the former approach could and should operate in light of the new system proposed in the Guide.

As discussed above, broadly speaking, there are two general approaches to IP secured financing. Some states finance IP assets under a system that relies on “possession” concepts and devices. Other states use “title” concepts and devices. In each of these states some IP assets are subject to filing systems, for example, patents and trademarks, while others are not, for example, copyrights and trade secrets. Thus, it is necessary to evaluate each of the five general areas in the Guide (creation, effectiveness, priority, enforcement and choice-of law) against the two general approaches to IP financing (“possession” vs. “title” systems) in light of whether or not there is a filing system. This yields four categories against which to evaluate each of the five issues: (i) non-possessory financing system with no IP register; (ii) non-possessory financing system with an IP register; (i) title-based financing system with no IP register; and (iv) title-based financing system with an applicable IP register.

In addressing these matters on the issue-by-issue approach suggested in the Guide the same basic policy question regularly arises: which is better, to facilitate specific commercial practices in IP, or to enable general secured lending practices? The IP statutes are generally directed at fostering the creation and dissemination of new items of IP using an “asset-specific” approach. The financing system recommended in the Guide tends to favor “enterprise” financing in which a grantor is given maximum flexibility to use its moveable property assets for security to facilitate cash-flow financing for the on-going operation of the enterprise. These approaches can produce tension in cases where a licensor subject to a financing for specific IP licenses rights grants a license to a licensee subject to a pre-existing enterprise financing. Some of these issues will be discussed further below.

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<sup>88</sup> UNCITRAL Guide, Commentary Part I para. 8.

## **B. What Intellectual Property Interests Should Be Capable of Financing?**

The next question to consider is the IP interests that should be capable of secured financing. While there may be a desire to include as many interests as possible, it must also be recognized that IP law often restricts using certain interests as collateral for loans in order to promote other policies. Thus, it may be necessary to address the interests that are available for secured lending.

### **1. Secured Financing Perspective**

While historically only certain types of assets were available for secured financing, from a modern secured financing perspective, all types of assets should be capable of being used as security except those specifically excluded.<sup>89</sup> This is the approach in UNCITRAL Guide. It embraces all types of moveable assets, including inventory, equipment and goods, as well as intangibles such a contract rights, receivables, negotiable instruments and, in principle, IP assets. Under the Guide, the person who creates the security right is called a “grantor”; the person who owes the obligation is a “debtor.” While they may be the same, this is not always the case, as, simplistically, when a parent grants a security right to secure an obligation of a child.

Under the Guide, a grantor need not be the “owner” of an asset in order to grant a security right. Rather, the security right can extend to whatever interest the grantor may have that is capable of being transferred for security.<sup>90</sup> Similarly, it is not necessary for the grantor to be the current owner of an asset. A grantor may also grant an effective security right in “future assets” that it creates or acquires after the security agreement is concluded without the necessity of signing additional documents.<sup>91</sup>

Thus, the goal of the Guide is to allow a grantor to use all of their assets to the fullest extent possible as collateral. So doing can help reduce the cost of credit. Allowing grantors to describe their assets in generic terms also reduces transaction costs involved in investigating whether a specific asset is or is not included under the security right.<sup>92</sup>

Of course, in adopting this approach, the Guide does not alter the underlying property rules for any asset. Put another way, as a general matter, the law recommended “does not override provisions of any other law to the extent that they limit the creation or enforcement of a security right in, or the transferability of, specific types of asset.”<sup>93</sup> One exception has to do with the assignability of certain receivables, which is discussed in the next section.

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<sup>89</sup> See UNCITRAL Guide, Part I para. 5.

<sup>90</sup> See UNCITRAL Guide, Part. I para. 6.

<sup>91</sup> See UNCITRAL Guide, Part I para. 8.

<sup>92</sup> See UNCITRAL Guide, Part I, para. 9.

<sup>93</sup> UNCITRAL Guide, Recommendation 18. Also, IP Annex, WP.37 Add. 1, para. 3: “In line with general rules of property law, the right to be encumbered has to be transferable under general property law and law relating to intellectual property law. It should be noted that, with the exception of statutory limitations to the assignability of future receivables and receivables assigned in bulk, the law recommended in the *Guide* does not override provisions of any other law (including law relating to intellectual property) to the extent that they limit the creation or enforcement of a security right in or the transferability of specific types of asset, including intellectual property (see recommendation 18).”



## 2. Intellectual Property Perspective

As mentioned above, the international conventions generally provide that IP assets should be transferrable by assignment or license. This should include a transfer by way of security and, indeed, numerous national laws allow the grant of a security right in IP. In general, IP law also allows the grant of a security right in “future intellectual property,” such as granting a publisher rights in a novel to be written or a distributor rights in a movie to be produced.<sup>94</sup> Thus, many of the normal practices in IP commerce will fit into the “unitary and functional “security right proposed in the Guide.

In some cases, however, specific IP laws may limit the ability to transfer certain IP interests, and this would restrict their ability to be used as security. For example, “moral rights” or authors or generally considered personal and non-transferrable.<sup>95</sup> In some countries, the economic rights of authors may not be transferred for security, although proceeds may be.<sup>96</sup> Some countries allow a security right in a patent application before a patent is issued<sup>97</sup>, while others do not.<sup>98</sup> It is often provided that licenses are not transferrable without the consent of the IP owner,<sup>99</sup> although an exception is allowed in case the license is transferred as part of a transfer of the entire enterprise.<sup>100</sup> As matter of secured financing law, and in particular due to Recommendation 4(b), the law recommended in the Guide respects these restrictions on transferability.

One particular case needs consideration: royalties. Under the Guide, IP royalties are treated as “receivables.” The Guide contains two recommendations regarding limitations on their transferability. Recommendation 23(a) proposes eliminating legislative restrictions on the assignment of future receivables, receivables assigned in bulk and parts of or undivided interests in receivables.<sup>101</sup> Recommendation 24(a) recommends allowing the assignment of a receivable to be effective notwithstanding any agreement between the initial or any subsequent assignor and the debtor of the receivable or any subsequent assignee limiting the assignor’s right to assign its receivables. Recommendation 24(b) provides that a party to the original contract may not avoid the original contract solely due to a breach of the “anti-assignment” provision. These recommendations apply to intellectual property royalties,<sup>102</sup> subject of course to Recommendation 4(b).

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<sup>94</sup> See IP Annex, WP.37 Add. 1 paras. 60 -64, discussing issues.

<sup>95</sup> E.g. United Kingdom, Copyright, Designs and Patents Act 1988, 1988 Chpt. 48, Art. 95.

<sup>96</sup> E.g., Mexico, Federal Law on Copyright (*Ley Federal del Derecho de Autor* of 24 Dec. 1966) Art. 41: “Economic rights may not be either attached or pledged, but the benefits and products from the exercise thereof may be so used.”

<sup>97</sup> See United States, Patent Act, (Title 35 U.S.C. sec. 261) (“Applications for patent, patents, or any interest therein, shall be assignable in law by an instrument in writing.”)

<sup>98</sup> See Japan, Patent Law (Law No. 21 of April 13,1959 as amended) Art. 33(2): “The right to obtain a patent may not be subject to a pledge.”

<sup>99</sup> See Germany Copyright Law (*Urheberrechtsgesetz* of 9 Sept. 1965 as amended) Art. 34 :1 “An exploitation may be transferred only with the author’s consent.” Spain, Consolidated Law on Intellectual Property (*Texto refundido de la Ley de Propiedad Intelectual* Official Bulletin No. 97 April 22, 1996, p. 14369 *et seq.*) Art. 49: “A transferee holding exclusive rights may further transfer his rights to another person with the express consent of the transferor.”

<sup>100</sup> See Germany Copyright Law (*Urheberrechtsgesetz*) Art. 34(3); Japan, Patent Law (Law No. 121 of April 13,1959 as amended); Art. 94(1); Spain, Consolidated Law on Intellectual Property Art. 49.

<sup>101</sup> UNCITRAL Guide Recommendation 23; also IP Annex, WP.37 Add.1 para. 66.

<sup>102</sup> UNCITRAL Guide Recommendation 24(c)(ii)

The purpose of these provisions is to facilitate the financing of receivables. On the one hand, they restrict the ability of a large debtor to prevent a smaller creditor from using its receivables as collateral. They also relieve the assignee of a bundle of receivables of the cost of having to examine each of the contracts from which the receivable arose to determine transferability, thus potentially reducing financing costs.<sup>103</sup>

However, application of Recommendations 23 & 24 in the Guide to IP royalties will require some care. As the IP Annex notes, in many states IP royalties, such as an author's right to various forms of equitable remuneration, may not be transferrable prior to actual receipt or may only be exercisable through, i.e. transferrable to, a collective management society. As the IP Annex notes, the Guide generally respects these restrictions under Recommendation 18, and, of course, Recommendation 4(b) as part of IP law proper.<sup>104</sup>

For example, in the European Union, the Rental Directive<sup>105</sup> provides for an "unwaivable" right of equitable remuneration payable to an author or performer who has assigned the rental right concerning a phonogram or an original copy of a film to a phonogram or film producer.<sup>106</sup> Administration of the right to equitable remuneration may be entrusted to a collecting society.<sup>107</sup> This "equitable remuneration" would seemingly qualify as a "receivable" by the entitled authors and performers. Even though the requirement to pay arises by law, the amount and conditions of payment are established by contract between the collecting societies and parties making payment. Implementing legislation typically provides that the right to receive payment, i.e., the "receivable, is not transferrable in advance except to a collecting society.<sup>108</sup> Similar restrictions apply to other levy schemes, such as for *droit de suite*, private copying, secondary broadcasts by cable systems, and blank tape levies.

Legislation typically restricts the ability of entitled parties to assign the right to payment to facilitate specific policies in IP law. In many cases, the party paying the equitable remuneration will be a transferee engaged in exploiting the IP, such as film producer, record company or broadcaster. It is sometimes feared that these parties will have greater bargaining power than the authors and performers and may therefore, unless prevented legislatively, contractually require payment of all income from exercise of the relevant right to them without any payment to the author or performers. Thus, the legislation prevents assignment of the equitable remuneration to ensure that authors and performers actually receive payment.

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<sup>103</sup> See UNCITRAL Guide, Part II para. 105.

<sup>104</sup> See IP Annex, WP.37 Add. 1 para. 65.

<sup>105</sup> Directive 2006/115/EC of the European Parliament and of the Council of 12 Dec. 2006 on rental right and lending right and on certain rights related to copyright in the field of intellectual property (codified version) O.J. 2006 L 376 ("Rental Directive").

<sup>106</sup> Rental Directive Art. 4.

<sup>107</sup> Rental Directive Art. 4(3).

<sup>108</sup> E.g. See Germany Copyright Law (*Urheberrechtsgesetz*) of 9 Sept. 1965 as amended, Art. 21(1): "It [the equitable remuneration from rental] may only be assigned in advance to a collecting society." Ireland, Copyright and Related Rights Act, 2000 (Law No. 28), Art 125(2): "The right to equitable remuneration conferred by this section shall not be waived by the author and the author shall not assign the right to equitable remuneration except to a collecting society for the purpose of enabling the collecting society to exercise that right on his or her behalf. Spain, Consolidated Law on Intellectual Property (*Texto refundido de la Ley de Propiedad Intelectual* Official Bulletin No. 97 April 22, 1996, p. 14369 *et seq.*) Art. 90(2) ("unrenounceable right to receive equitable remuneration from rental") and 90(7) ("shall be exercised through" collecting societies);

It should be noted that many of these same results occur by contract in other areas of IP commercial practice. For example, in the music industry, it is common to authorize collective management of rights and for the collecting societies to limit by contract the parties to who collections may be made, e.g., sharing collections equally between publishers and composers regardless of individual contractual arrangements.

As a result, when it comes to IP interests, different policy concerns come into play. For what might be called “trade receivables,” *i.e.*, receivables arising from a sale of goods, the UNCITRAL Guide proposes to *eliminate* legislative and contractual restrictions on account creditors to facilitate financing and to prevent large debtors from restricting the ability of small creditors to obtain financing. But for IP royalties, IP law may *endorse* legislative and contractual restrictions on the assignability of royalties precisely to protect the same small creditor, for example, authors and performers, from large transferees who might otherwise demand an assignment of equitable remuneration for exercise of a specific right to themselves. Applying the Guide’s policy of eliminating restrictions on assignability of trade receivables to IP royalties could have the perverse effect of undermining the policy protections of small creditors both the Guide and IP law intend to foster, just as application of the IP rules restricting assignability of royalties would have inappropriate consequences if applied to all forms of trade receivables.

Thus, in light of Recommendation 4(b), it would seem that Recommendations 23 and 24 in the Guide should not be applied to IP royalties in a variety of circumstances.

### **C. How Should a Security Right Obtain Effectiveness Against Third Parties?**

A core policy of secured financing law is providing some notice of the financing arrangement to third parties, at least with respect to tangible assets. Such notice is considered essential to avoid extending improvident credit based on the appearance of wealth given by mere possession. Thus, in secured financing law, a secured creditor must typically take some steps to give notice of the existing of the financing arrangement in order to make the security right effective against third parties. Questions again arise about how such practices should operate when the secured collateral is IP.

#### **1. Secured Financing Perspective**

In secured financing, the concept of effectiveness against third parties is different from that of priority. Effectiveness is an essential step for priority, but the priority rules may vary depending on the different means by which a secured right is made effective.<sup>109</sup> For purposes here, the focus is on issues of effectiveness. Priority is discussed separately below.

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<sup>109</sup> See UNCITRAL Guide, Commentary V para. 27, which provides: “A basic rule is the general principle that a security right cannot have priority over the right of a third party unless the security right is “effective” as against that third-party. This is the position recommended in the Guide. Only in such cases can a question of priority arise. As a consequence, the priority rules recommended in the Guide are closely correlated with the different methods through which third-party effectiveness of the security right may be achieved.”

The UNCITRAL Guide begins by separating the concept of creation of a security right from third party effectiveness. Thus, execution of a proper security agreement creates a security right that is effective between the grantor and secured creditor.<sup>110</sup> However, the Guide adopts the basic policy approach that a secured creditor must give appropriate notice of the financing to make it effective against third parties. For intangible assets where taking physical possession is not an option, such as IP, the method for so doing is to file an appropriate notice of the financing. However, where the assets are IP, the Guide proposes three rules to determine whether the filing should be made.

The first rule is Recommendation 4(b), which says the law recommended in the Guide does not apply “in so far as [...] inconsistent with national law [...] relating to intellectual property.” Thus, if a state’s IP law makes filing evidence of a security right in specialized intellectual property register the exclusive means for creation or for third party effectiveness of a security right, then that law prevails.<sup>111</sup> For example, if under a state’s industrial property law the only way to make security right in a patent effective against third parties is to file in the national patent office, then that requirement will continue under the Guide.

However, if Recommendation 4(b) does not apply, then the Guide’s basic response is “either/or.” That is a secured creditor can file in either the general security rights registry proposed in the Guide or a specialized IP registry to achieve third party effectiveness. Thus, Recommendation 32 says a state should allow a security right to be made effective against third parties by filing a notice in the Guide’s general security rights registry.<sup>112</sup> However, Recommendation 38 adds that where a state already has a specialized registry for filing security rights against certain types of property, then the state should allow use of that registry as an alternative method of achieving third party effectiveness.<sup>113</sup> In other words, a secured creditor can use either one. However, the Guide also proposes a priority rule that a security right filed in a specialized registry, such as in a national patent or trademark office, takes priority over one filed in the general security rights registry.<sup>114</sup> This encourages use of the specialized registry to for a secured creditor to achieve “maximum protection.”

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<sup>110</sup> UNCITRAL Guide, Recommendation 13.

<sup>111</sup> See, for example, Japanese Patent Law Art. 98(1) (“The following shall have no effect unless they are registered: [...] (iii) [...] a pledge on a patent or a patent right or exclusive license, or a restriction on the disposal thereof”); and the Swedish Patent Act. Art. 95 (“A pledge of a patent or patent application arises by registration of a written contract pledging the property. The application for registration is made with the Patent Authority”).

<sup>112</sup> See UNCITRAL Guide, Recommendation 32, which provides: “The law should provide that a security right is effective against third parties if a notice with respect to the security right is registered in the general security rights registry referred to in recommendations 54-75 (chapter IV on the registry system).”

<sup>113</sup> See UNCITRAL Guide, Recommendation 38, which provides: “The law should provide that a security right in a movable asset that is subject to registration in a specialized registry or notation on a title certificate under other law may be made effective against third parties by registration as provided in recommendation 32 or by: (a) Registration in the specialized registry; or (b) Notation on the title certificate.”

<sup>114</sup> See UNCITRAL Guide, Recommendation 77, which provides: “The law should provide that a security right in an asset that is made effective against third parties by registration in a specialized registry or notation on a title certificate, as provided in recommendation 38 (chapter III on the effectiveness of a security right against third parties), has priority as against: (a) A security right in the same asset with respect to which a notice is registered in the general security rights registry or which is made effective against third parties by a method other than registration in a specialized registry or

## 2. Intellectual Property Perspective

The Guide's approach to effectiveness raises two issues for IP: where to file and when to file. These issues arise due to the different operation of specialized IP registers and the general security rights registry proposed in the Guide.

### (i) Where to file:

For IP assets, the question of where to file can yield different answers depending on whether a state's current secured financing law, and resulting implementation in the IP statutes, derives from pledge (possession) or mortgage (title) concepts.

a) *Possession Systems:* In states that currently use "possession" systems, filing in an applicable registry is typically a pre-requisite to making a security interest in IP effective against third parties. A few states provide that a non-possessory pledge of IP is not effective even between the debtor and creditor without a filing.<sup>115</sup> Other states provide that the non-possessory pledge is effective between the parties, but is not effective against third parties unless and until a timely filing is made. In states with non-possessory pledge laws where no registry exists for certain types of IP, such as copyrights or trade secrets, the IP is often effectively unfinanceable. In a few states, however, financing is possible by filing in the general security rights system

Thus, if such a state adopts the Guide, the results will depend on whether or not there is an existing filing system for the applicable IP. For those types of IP where no filing system currently exists, such as for copyrights or trade secrets, a secured creditor may now file in the general security rights registry proposed in the Guide. The result is that this will allow financing of IP assets that were previously not financeable at all. However, as discussed below, the commercial results may be different for asset-centric and enterprise-centric financing. Where a filing system does exist for specific IP, such as for patents and trademarks, if IP law makes filing in the specialized register the exclusive means to achieve third party effectiveness, that rule will prevail. Otherwise, a secured creditor may file either in the specialized IP registry or the Guide's general security rights registry.

b) *Mortgage Systems:* In states that allow "title" devices, the general view is that a security transfer, such as a mortgage, is effective against third parties when it is created. Thus, the key inquiry is really whether the security right will lose *priority* such as by failure to make a timely filing.

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[Footnote continued from previous page]

notation on a title certificate, regardless of the order; and (b) A security right that is subsequently registered in the specialized registry or noted on a title certificate."

<sup>115</sup> For example, E.g. Austria, Patent Law (Federal Law of 1970) Art. 43(1): "Patent rights liens and other rights *in rem* relating to a patent shall be acquired by entry in the Patent Registry and shall be binding on third parties." Japan, Patent Law (Law No. 121 of April 13, 1959 as amended); Art. 98(1): "The following are of no effect unless they are registered: [...] (iii) [...] a pledge on a patent right [...]." Sweden, The Swedish Patent Law (Act. No. 837 of 1967 as amended) Art. 95: "A pledge of a patent or patent application arises by registration of a written contract pledging the property. The application for registration is made with the Patent Authority."

In states using title-based devices where there is no filing system, the usual priority rule is “first in time.” If this is not a specific rule of IP law, then a secured creditor will need to file in the Guide’s general security rights registry to make the security right effective against third parties. This may lead to something of a mismatch between IP law and secured financing law. Currently in such situations, any party, including a lender, who wishes to take an interest in IP, must search the chain of title as best as possible to find prior interests, including security rights. Such a search will still be required for prior ownership interests even if the Guide is adopted. However, the Guide’s approach will require an additional search of the general security rights register to find prior security rights. The search must consider each prior party in the chain of title, not merely the immediate grantor.

Under the Guide, security rights are not limited solely to “bank loans.” A licensor who seeks a security right in its claim to royalties from sublicensing income (a “receivables financing”)<sup>116</sup> may also need to file a notice to make its claim to royalties effective against third parties.<sup>117</sup> This means that licensors and their lenders who were content to rely on contract terms and a “first in time” priority rule for claiming sub-licensing royalties may find they must make a filing for effectiveness and resulting priority. On the other hand, enterprise lenders to licensees will now have an effective means to make their claims to any of its future sub-licensing royalties effective against third parties. Thus, adopting the Guide in such a state requires a choice: either foster the Guide’s policies of encouraging financing generally by requiring a change in current intellectual property practices, or continue current IP practices but deviate from the Guide’s general financing system. Each choice imposes costs and benefits on interested parties.

A somewhat different analysis applies in states that use “title” based devices where there is a filing system for applicable IP. In that case, results will depend on the applicable filing rules used by the filing system. These issues are addressed in the next section.

(ii) When to file:

A second issue is when to file. Of course, a secured creditor is encouraged to file as soon as possible. The real issue arises in case of a transfer of the IP collateral. However, this issue is particular to filings in the Guide’s general security rights registry. It does not apply to filing in a specialized IP register. The reason is because of differences in the indexing systems.

In IP registers, filings are indexed against the property. Thus, searching is done by property and it is easy to find prior transfer for *that* property. In the general security rights registry, however, filings are indexed against the grantor. That means if collateral is transferred it is hard to find prior security rights by searching the current owner. Consider:

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<sup>116</sup> See IP Annex, Add. 1 para. 44, which provides: “If a licensor is not an owner but a licensee that grants a sub-licence, typically, it may create a security right in its right to receive payment of royalties owed under the sub-licence agreement.”

<sup>117</sup> See IP Annex, Add. 3 para. 12, which provides: “Where the encumbered intellectual property is not registrable in a specialized registry, priority [as between a licensor’s lender and licensee’s lender in sublicensing royalties] will be determined by the order of registration of a notice of the security right in the general security rights registry.”

*Example:* On Day 1, IP Owner grants Lender a security right in its IP. Lender duly files notice in the general security rights registry. On Day 2 IP Owner assigns the IP to Assignee. On Day 3 Assignee grants Licensee an exclusive license in the IP. On Day 4, Licensee grants Bank a security right in its licensed IP. Lender does not make any filing against Assignee or Licensee. Is Lender's security right in the IP effective against them or Bank?

This example raises the question of what steps, if any, the Lender must take to maintain effectiveness of its security right against third parties in case of a transfer where the security right is filed in the general security rights registry. This issue was debated when preparing the Guide and the result is a compromise. Recommendation 31 says a security right that is effective against third parties continues to encumber the asset after a transfer unless there is a lapse in registration,<sup>118</sup> but Recommendation 65 leaves it for states to pick when lapse occurs.<sup>119</sup> The Guide has three choices:<sup>120</sup> (i) the secured creditor must file an amendment naming the transferee within a specified time after the transfer to preserve priority over intervening parties; (ii) the secured creditor must file an amendment naming the transferee within a specified time after obtaining notice of the transfer to maintain priority; and (iii) the secured creditor need not file to maintain priority against intervening parties. Of course, no issue arises if the secured creditor authorizes the transfer free of the security right.

The current draft of the IP Annex does not take an approach on this issue, merely reflecting the alternatives in the Guide and indicating states will have to consider which approach to apply to IP.<sup>121</sup> There has been some suggestion that states should adopt the third approach for IP, regardless of the approach for other assets, due to the different commercial practices and legal requirements for IP.

A transfer of collateral becomes an issue for the general security rights registry because it indexes filings against a grantor. "Subsequent change in the grantor's name or other applicable identifier raises problems for the discovery of previously registered notices. The grantor's identifier is the principal search criterion and a search using the grantor's new identifier will not disclose a security right registered against the old name."<sup>122</sup> Thus, a trade-off is necessary. Should secured creditors be required to police their grantors to make sure they are not making unauthorized transfers of collateral? Or should third parties be required to investigate prior owners of collateral to find pre-existing security rights? Since the issue usually arises in the case of an unauthorized transfer of collateral, it often requires choosing between two innocent parties, the prior secured creditor who was unaware of the unauthorized transfer and the subsequent transferee who was unaware of the prior security right.

Different commercial expectations, however, apply to IP. For tangible moveable property, the usual expectation is that security rights do not continue after a sale. The Guide

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<sup>118</sup> UNCITRAL Guide, Recommendation 31 provides: "The law should provide that, after transfer of a right other than a security right in an encumbered asset, a security right in the encumbered asset that is effective against third parties at the time of the transfer [...] remains effective against third parties except as provided in recommendation 65."

<sup>119</sup> UNCITRAL Guide, Recommendation 65 provides: "The law should address the impact of a transfer of an encumbered asset on the effectiveness of registration."

<sup>120</sup> UNCITRAL Guide, Commentary Part IV para. 78-80.

<sup>121</sup> IP Annex Add. 2 para. 30-36.

<sup>122</sup> UNCITRAL Guide, Commentary Part IV para. 75.

facilitates this approach by priority rules which provide that buyer or lessee of goods “in the ordinary course” takes free of a prior security right<sup>123</sup> While this does not mean a security right never continues, it does mean that parties dealing with a seller in authorized possession of goods typically does not, and need not, factor searching for such interests into transaction costs. But for IP the opposite is true. It is routine for restrictions in prior transfers, including security rights, to “carry forward” and condition later transfers, so that it is routine to include the costs of finding and dealing with such interests into transaction costs. Since later transferees of IP routinely search for prior transfers in the chain of title (or obtain financial concessions or indemnities to cover any risk of loss), the “extra” burden on later transferees in finding prior security rights is minimized.

#### **D. What Rules Determine a Secured Creditor’s Priority Over Third Parties?**

A key concept for both secured financing law and IP law is “priority.” The idea is that one party may use an asset to the exclusion of – with “priority” over – other competing claimants. While both laws utilize the concept, they do so for different interests and with different priority systems. These priority rules are in turn tightly integrated with the filing systems used by each body of law. This is another area where it is necessary to address the varying approaches in secured financing law and IP law.

##### **1. Secured Financing Perspective**

As applied to IP assets, the Guide proposes a tier of three different priority rules: (i) total displacement of the Guide’s priority rules under Recommendation 4(b); (ii) otherwise, if a specialized IP register applies, dual filing with the IP register having priority; and (iii) otherwise, if no specialized register applies, use of the Guide’s basic priority system for intangible assets generally.

The basic rule is Recommendation 4(b). It provides that the Guide does not apply “in so far as the provisions of the law are inconsistent with national law or international agreements, to which the State is a party, relating to intellectual property.” Many states have IP statutes whose priority rules also apply to security rights. In such cases, these IP priority rules would apply and supersede any inconsistent rules in the Guide. As the IP Annex notes, “[i]f law relating to intellectual property has priority rules dealing with the priority of security right in intellectual property that apply specifically to intellectual property and the priority rules of the law recommended in the Guide are inconsistent with those rules, the law recommended in the Guide does not apply (see recommendation 4, subparagraph (b)).”<sup>124</sup>

If a state’s IP law does not have a priority rule for security interests in a particular type of IP (*e.g.* because the filing system does not cover security rights), or if the recommendations in the Guide are not inconsistent with those rules (*e.g.*, the IP priority rules are the same as those in the Guide) then the priority rules recommended in the Guide will apply.<sup>125</sup> In that case, the Guide proposes different priority rules depending on whether or not it is possible to make the security rights effective against third parties by filing in a specialized IP registry.

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<sup>123</sup> UNCITRAL Guide, Recommendation 81.

<sup>124</sup> IP Annex para. 48.

<sup>125</sup> IP Annex, para. 48.



If a state allows security rights to be filed in a specialized IP registry, then Recommendations 77 and 78 in the Guide provide in relevant part:

“77. The law should provide that a security right in an asset that is made effective against third parties by registration in a specialized registry ... has priority as against:

(a) A security right in the same asset with respect to which a notice is registered in the general security rights registry... regardless of the order; and

(b) A security right that is subsequently registered in the specialized registry ....

78. The law should provide that, if an encumbered asset is transferred, leased or licensed and, at the time of transfer, lease or licence, a security right in that asset is effective against third parties by registration in a specialized registry .... the transferee, lessee or licensee takes its rights subject to the security right, except as provided in recommendations 80-82. However, if the security right has not been made effective against third parties by registration in a specialized registry ... a transferee, lessee or licensee takes its rights free of the security right.”

Under these rules, a security right filed in the specialized IP registry takes priority over one filing in the Guide’s general security rights registry regardless of the time of filing.<sup>126</sup> Knowledge of the other security right does not affect priority.<sup>127</sup> To see how this works, consider the following example:

*Example:* On Day 1 Grantor grants Lender a security right in all “existing and later acquired IP and royalty receivables.” Lender files a notice in the general security rights register. On Day 2, Grantor licenses IP from Licensor, who takes a security right in Grantor’s IP and licensing income to ensure payment of its royalties. Licensor files in an applicable specialized IP register. What result?

If applicable law provides that allows Licensor’s security right to be filed in the IP registry with third party effects, under Recommendation 77, Licensor’s security right has priority over Lender’s security right even though it was filed after Lender’s.

It should be noted that not every IP registry qualifies as a “specialized” registry under Recommendations 77 and 78. The registry must be one that produces “third party effects,” *i.e.* one which allows filing security rights and which provides that such filing makes the security right effective against third parties.

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<sup>126</sup> IP Annex, para. 50.

<sup>127</sup> See UNCITRAL Guide, Recommendation 93, which provides: “The law should provide that knowledge of the existence of a security right on the part of a competing claimant does not affect priority.”

If a specialized IP registry is unavailable (and Recommendation 4(b) does not apply), then the basic priority scheme in the Guide for intangible property applies. Under this system, as between two conflicting security rights made effective against third parties by registration, the first one to register in the Guide's general security rights register prevails.<sup>128</sup> Again, knowledge of a prior security right does not affect priority.<sup>129</sup>

It is important to note that the Guide's priority rule applies regardless of the time of creation of the security rights. As the Guide explains,<sup>130</sup> it is possible to *register* notice of a security right before the security right is *created*. For example, assume Bank A enters into a loan commitment and security agreement with Debtor on Day 1 and files a notice in the Guide's general security rights registry that day. However, Bank A does not make the loan and advance funds until Day 5, which is the date on which the security right is created. However, on Day 2 Debtor enters into a second security agreement with Bank B. On Day 2 Bank B does advance funds and also files a notice in the Guide's general security rights register. Under the Guide, even though Bank A's security right was not created until after Bank B's security right, Bank A would have priority because it was the first to file.<sup>131</sup>

In order to see how this works in an IP context, consider the previous example:

*Example:* On Day 1 Grantor grants Lender a security right in all "existing and later acquired IP and royalty receivables." Lender files a notice in the general security rights register. On Day 2, Grantor licenses IP from Licensor, who takes a security right in Grantor's IP and licensing income to ensure payment of its royalties. Licensor files in the general security rights register. What result?

Under the Guide, since Lender filed first in the general security rights register, it would prevail. This priority would occur even if Lender had not advanced any funds with respect to the licensed IP. Alternatively, assume that Licensor had delivered to Grantor 1,000 pairs of trademarked jeans along with a trademark license to make and sell more jeans under the mark. Curiously, at least as of this writing Licensor could obtain priority over Lender with respect to the 1,000 pairs of jeans ("goods") by filing timely notice in the general security rights register that it had reserved an "acquisition financing security right," but could not do so for the trademark license ("intellectual property") because the Guide does not allow acquisition financing for IP.<sup>132</sup> This issue is still under consideration in the IP Annex.

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<sup>128</sup> See UNCITRAL Guide, Recommendation 76(a), which provides: "As between security rights that were made effective against third parties by registration of a notice, priority is determined by the order of registration, regardless of the order of creation of the security rights."

<sup>129</sup> See UNCITRAL Guide, Recommendation 93, which provides: "The law should provide that knowledge of the existence of a security right on the part of a competing claimant does not affect priority."

<sup>130</sup> See UNCITRAL Guide, Commentary, Part V, paras. 46-50.

<sup>131</sup> See UNCITRAL Guide, Commentary, Part V para. 47 (the basis for the example in the text).

<sup>132</sup> See UNCITRAL Guide, Chpt. IX (discussing acquisition financing).

## 2. Intellectual Property Applications

States must consider how the priority rules in the UNCITRAL Guide will interact with their existing priority rules for IP transfers. Again, the approaches will vary somewhat depending on whether the current priority rules were crafted to deal with a financing system that derived from possession-based or title-based concepts.

### (i) Possession Systems:

With respect to states whose current secured financing law is a possession-based system, application of the priority rules in the Guide will vary for different types of IP depending whether or not a filing system currently exists.

For IP assets for which there is a filing system, such as for patents and trademarks, it will be necessary to determine whether the filing system already has a priority rule that applies to security rights. In some countries, the applicable intellectual property law specifically addresses the priority accorded to security rights (“pledges”) filed in the relevant IP filing system.<sup>133</sup> Other countries allow for the filing of security rights in the registry, but do not provide an express priority rule,<sup>134</sup> or only provide that the filing is presumptive evidence of validity.<sup>135</sup> Still other countries allow filing of assignments or transfers with respect to the IP and provide that unregistered assignments or transfers do not become effective against third parties until registration occurs.<sup>136</sup> It is not clear in many laws whether security rights may be filed as allowed “assignments” or “transfers” in their own right. If they are not, it is also unclear whether a security right may be granted at all. If it can, what would the priority between an unregistered security right and a later filed transfer? In these instances states will need to consider clarification of their existing IP laws to determine whether evidence of the security right as proposed in the Guide can be registered in an applicable IP register and if so what the priority rule should be. As discussed above, the international IP conventions do not require any particular priority rule so long as whatever priority rules is adopted leads to a consistent answer for all types of transfers, as this is necessary to preserve exclusivity rights. This would include to using the same priority rule for normal transfers as well as transfers for security.

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<sup>133</sup> E.g. Sweden, Swedish Patent Law (Act. No. 837 of 1967 as amended) Art. 95: “... priority is given that pledge for which an application for registration was first received by the Patent Authority ...”

<sup>134</sup> E.g. China, Implementing Regulations for Patent Law of People’s Republic of China (Decree No. 306 of State Council of June 15, 2001) Art. 88 (providing for filing pledges in Patent Register without explicit priority rule); Japan, Patent Law (Law No. 121 of April 13, 1959, as amended) Art. 98 (providing a pledge of a patent is not effective unless registered without explicit priority rule).

<sup>135</sup> Spain, Consolidated Law on Intellectual Property (*Texto refundido de la Ley de Propiedad Intelectual* Official Bulletin No. 97 April 22, 1996, p. 14369 *et seq.*) Art. 53 (allowing for a pledge of copyrights) Art. 145 (allowing for registration in Intellectual Property Register) and Art. 145(3) (“In the absence of proof to the contrary, it shall be presumed that the rights registered exist and belong to their owner in the form specified in the relevant registry.”)

<sup>136</sup> E.g. Brazil, Law No. 9,279 of May 14, 1996, Art. 130(1) (allowing titleholder of mark to assign the mark) and Art. 134 (allowing for assignment of registrations) and Art. 137 (providing that entries only become effective against third parties on their date of publication); Colombia, Decision 486 on Common Provisions on Industrial Property (of September 14, 2000) Art. 56 (allowing for “transfer” of a patent but requiring registration in the national patent office and providing “Failure to register shall cause the transfer to be unenforceable against third parties.”); Oman, Royal Decree No. 82/2000

For IP assets in which there is no filing system, such as copyrights in some countries and trade secrets, in countries using pledge-based systems these assets are often current not financeable at all. Thus, there is often no specific priority rule applicable to security rights in these IP assets since they effectively do not exist. In these cases, the Guide allows for filing notice of the security right in the Guide's general security rights registry, which now makes these assets effectively financeable. In such a case, since there is no specialized IP registry, the Guide would use the same priority rules for IP assets as for general intangibles, i.e., generally, its "first to file in the general security rights registry" rule. However, a word of caution is required here. In countries where there is no IP registry, the IP assets are still transferrable. In such cases, the usual priority rule for outright (non-security) transfers is "first in time" based on the *nemo dat* principle. This leads to a potential mismatch, as *ownership* transfers would be evaluated under the "first in time" priority rule, while *security* transfers would be subject to the different priority rules in the Guide. There are certain exceptions to the priority rules in the Guide that do not apply to outright transfers, such as for "acquisition financing rights" and "licensees in the ordinary course." Reconciling these matters is still under discussion in drafts of the IP Annex.

(ii) Title Systems:

For states whose current secured financing law is a title-based system, application of the priority rules in the Guide will again vary depending whether a filing system currently exists.

For IP assets for which there is a filing system, it will also be necessary to determine whether there is a priority rule for security rights. In some countries, the effectiveness of a security right ("mortgage") is determined by the order of filing in the applicable registry.<sup>137</sup> Other countries provide that as between two conflicting transfers the first one prevails unless the first one was not properly recorded in the applicable register (sometimes within a grace period) and the second one was not aware of the prior transfer, e.g., the second transfer is to a "bona fide purchaser."<sup>138</sup> In other cases, the IP law allows for an "assignment" of the IP and provides that such an assignment is ineffective if not registered<sup>139</sup>, but application to security rights is unspecified. In these cases, the priority rules in the IP statutes will apply in lieu of those in the Guide, although in the last mentioned case a clarification would be in order.

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Promulgating Patent Law Art. 13 ("Patent holder may assign all, or some, of the utilization rights .... The assignment may not be taken as proof until after being registered in the Patent register ...")

<sup>137</sup> E.g. Austria Patent Law (Federal Law of 1970) Art. 43(1) (allowing for filing of liens) and Art. 43(3): "The order of priority of the rights referred to shall be determined by the order in which applications for entry have reached the Patent Office, provided such applications lead to entry."

Mexico, Mexico, Federal Law on Copyright (*Ley Federal del Derecho de Autor* of 24 Dec. 1966) Art. 162 (V) (allowing registration of agreements to "encumber" economic rights) and Art. 171 (in case of conflict the first instrument registered prevails). Compare India, The Patent Act of 1970 (No. 39 of 1970) Art. 68 (providing that mortgages of patents are not effective unless filed in the Register of Patents within six month of their execution, but providing that the mortgage, when registered, is effective from date of execution.)

<sup>138</sup> United States, Copyright Act (Title 17 U.S.C. sec. 205) (mortgage of copyright); United Kingdom, The Patent Act of 1977 (as amended) Art. 33(1) (mortgage of patent).

<sup>139</sup> E.g. Nigeria, Chapter 344 Patents and Designs Act, Art. 24(1) (allowing assignment of a patent) and Art. 24(3) (providing assignment is ineffective against third parties unless registered.)

One detail should be noted. In some countries, as between two conflicting transfers, including security rights, the first in time prevails unless the second one is to a “protected party,” i.e., generally a good faith purchase<sup>3r</sup> without knowledge. In these countries it is not strictly necessary to file any notice of a security right in the IP to gain *effectiveness* against third parties, although a security right can lose *priority* to a “protected party” if it is not timely filed. If this priority rule is an exclusive rule of IP law, then, as the IP Annex confirms, the Guide defers to this rule.<sup>140</sup> That is, the security right is effective when made without the necessity of any filing, but may lose priority if not filed in the exclusive IP register.

For IP assets for which there is no filing system, it will also be necessary to determine IP law has a priority rule that applies to security rights. In some cases, the IP law may provide a specific priority rule.<sup>141</sup> In general, however, most IP laws where no registry system is involved simply authorize the making of transfers and leave the priority rule to general law. In that case, the usual priority rule is “first in time” based on the *nemo dat* principle. Under the Guide, Recommendation 4(b) is not intended to apply to general property law priority rules. As such, in these cases, the Guide would envision using the priority rules in the Guide with respect to security rights in these types of IP assets. Again, in implementing the Guide approach states should exercise caution to ensure that the priority rules for security rights do not lead to conflicts with the remaining priority rules for outright transfers generally.

#### **E. What Law Applies To an Intellectual Property Security Right?**

The commercial use of IP often involves multiple countries. This raises issues of the applicable law. On the one hand, commercial law generally looks to the law proper of the contract (*lex contractus*) which generally applies a single law to contractual issues across multiple countries, subject to mandatory contrary rules of the forum. IP law, on the other hand, uses the territorial principle under which the law of the protecting country applies, at least to enforcement of the IP rights, potentially leading to the application of multiple national laws.<sup>142</sup> Although such issues are common in IP professional practice, they nonetheless require some consideration in the context of IP security rights.

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<sup>140</sup> IP Annex, WP.37 Add.2 para. 6: “In other States, law relating to intellectual property provides that a security right is created and becomes effective against third parties when the security agreement is entered into, even without registration. In these cases, registration in the relevant intellectual property registry allows certain third parties, typically bona fide transferees without notice, to invoke a priority rule to take precedence over unregistered prior security right, but the unregistered security right still remains effective against other third parties. If [this] is intended to be the exclusive method of obtaining effectiveness of a security right against third parties, in accordance with recommendation 4, subparagraph (b), it takes precedence over any of the methods provided in the law recommended in the Guide.”

<sup>141</sup> E.g. United Kingdom, Copyright, designs and Patents Act of 1988 (1988 Chpt. 48) Art. 90(4) (providing a license is binding on every successor in title except a purchaser in good faith for value without notice);

<sup>142</sup> See generally Paul Edward Geller, *International Copyright Law and Practice*, (2008 ed.), discussion at Introduction.

## 1. Secured Financing Perspective

As indicated in the UNCITRAL Guide, conflict-of-law<sup>143</sup> rules for an efficient secured transaction regime should be easy to determine, certain in application, predictable in result, and match commercial expectations.<sup>144</sup> As such, the UNCITRAL Guide proposes several conflict-of-law rules that apply to security rights in intangible assets.

Initially, the Guide distinguishes the contractual rights between the parties and *in rem* rights in the financing transaction.<sup>145</sup> With regard to the contractual rights, the UNCITRAL Guide adopts the principle of party autonomy that the governing law should be the one chosen by the parties, or, in the absence of an effective choice, the law governing the security agreement.<sup>146</sup>

With regard to the financing transaction, however, the Guide recommends that “the law applicable to the creation, effectiveness against third parties and priority of a security right in an intangible asset is the law of the State in which the grantor is located.”<sup>147</sup> It also recommends that the “law applicable to the enforcement of a security right ... [i]n an intangible asset is the law applicable to the priority of a security right.”<sup>148</sup> Intangible assets include receivables.<sup>149</sup> Thus, the “location of the grantor” conflict-of-law rule applies to a security right in receivables, *i.e.*, as between the assignor and the assignee of the receivable. However, this does not change the law governing the payment obligation reflected in the receivable itself. Thus, as between the debtor on the receivable and the assignee, and the Guide recommends that “the law applicable to a receivable is also the law applicable to ... [t]he relationship between the debtor of the receivable and the assignee of the receivable.”<sup>150</sup>

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<sup>143</sup> The UNCITRAL Guide refers to its rules on applicable law as “conflict-of-law” rules in preference to “choice-of-law” or “private international law” rules. This paper will follow the same terminology.

<sup>144</sup> See UNCITRAL Guide, Part X, para. 6, which provides: “In an efficient secured transactions regime, conflict-of-laws rules applicable to ... the property aspects of a security right should be easy to determine. Certainty is a key objective in the development of rules affecting secured transactions both at the substantive and at the conflict-of-laws levels. Another objective is predictability. [...] A third key objective [...] is that the relevant rules should reflect the reasonable expectations of interested parties (i.e. creditor, grantor, debtor and third parties).”

<sup>145</sup> UNCITRAL Guide, Part X, para. 61, which provides: “[T]he scope of the rules on the creation, third-party effectiveness and priority of a security right is confined to the property (in rem) aspects of the right. These rules do not apply to the mutual rights and obligations of the parties to the security agreement. Such rights and obligations are instead governed by the law chosen by them or, in the absence of a choice of law, by the law governing the agreement ...”

<sup>146</sup> UNCITRAL Guide, Recommendation 216, which provides: “The law should provide that the law applicable to the mutual rights and obligations of the grantor and the secured creditor arising from their security agreement is the law chosen by them and, in the absence of a choice of law, by the law governing the security agreement.”

<sup>147</sup> UNCITRAL Guide, Recommendation 208.

<sup>148</sup> UNCITRAL Guide, Recommendation 218(b).

<sup>149</sup> UNCITRAL Guide, Commentary Part X, para. 41.

<sup>150</sup> UNCITRAL Guide, Recommendation 217(a).

In discussing its “law of the grantor” approach, the UNCITRAL Guide is primarily focused on a specific type of intangible – receivables. For example, the Commentary states<sup>151</sup>: “It is also the case that, while the law of the location of the encumbered asset (*lex situs*) works well in most instances for tangible assets, great difficulties arise in applying the *lex situs* to intangible assets, at both conceptual and practical levels. From a conceptual standpoint, there is no consensus and no clear answer as to the *situs* of a receivable.” However, in the case of IP intangibles, treaty obligations that already establish certain choice of law rules, and it is necessary to consider how these apply to an IP security interest.

The current IP Annex provides an extensive discussion of the issues involved.<sup>152</sup> It currently proposes three alternatives for discussion<sup>153</sup>:

*Alternative A:* The law should provide that the law applicable to the creation, effectiveness against third parties, priority and enforcement of a security in IP is the law of the State [or region] in which the IP is protected.

*Alternative B:* The law should provide that the law applicable to the creation and enforcement of a security right in IP is the law of the State in which the grantor is located. However, the law applicable to the third-party effectiveness and priority of a security right in IP is the law of the State [or region] in which the IP is protected.

*Alternative C:* The law should provide that the law applicable to the creation, third-party effectiveness, priority and enforcement of a security right in IP is the law of the State in which the grantor is located. However, the law applicable to a priority conflict involving the right of a transferee or licensee is the law of the State [or region] in which the IP is protected.]

It should be noted that this issue is still in flux, so other formulations of these positions may be considered.

## 2. Intellectual Property Applications

As mentioned, the IP conventions already contain conflict-of-law rules based on the territoriality principle. These rules derive from the fundamental principle that there is no “international” IP as such. Rather, IP involves an intangible right which can be enforced under the laws of each relevant national legal system. The value of IP assets derives from the ability to enforce it against third parties, and the scope of that enforcement depends on national law.

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<sup>151</sup> UNCITRAL Guide, Commentary Part X, para. 42.

<sup>152</sup> IP Annex, Part X.

<sup>153</sup> IP Annex, Part X para. 20.

The international conventions determine the conditions for this enforcement by requiring recognition of certain minimum rights, thus establishing a base line of protection, and national treatment, thus giving foreign parties the same protection a state accords to its own nationals. This system leads to a “territorial” approach to protection and consequent choice-of-law rules.

There is no specific rule in the international conventions that addresses “security rights” as such. However, as mentioned above, an IP secured creditor should be treated as a “right holder” in accordance with treaty norms, and hence should be entitled to assert treaty provisions to the extent of its interest. Thus, treaty choice-of-law rules need to be considered in relation to IP secured transactions.

The treaty provisions would lead to applying the “law of the protecting country” to issues that basically address the interaction of an IP security right with third parties. Thus, issues arising solely as between the grantor and the secured creditor would appear to be primarily “contractual” in nature and as such governed by the principle of party autonomy in the Guide. However, where issues of “creation” of the security right impact its existence as a *property* right, then the application intellectual *property* choice of law rules, that is the territorial principle, seems appropriate. Similarly, effectiveness of the IP security right against third parties, and its priority over other competing claimants, would also seem to require application of the territorial principle since these issues all impact enforcement of the IP rights.

Finally, when it comes to enforcement of a security right, it seems commercially impractical to conduct a separate foreclosure sale in every individual country covered by the security arrangement. If once conceptualizes a foreclosure sale as a type of “transfer” then it would be at least conceptually possible to see this as a single transfer subject to one law. However, whether the transfer would be recognized and enforced in another country would depend on the law of each particular country under the territorial principle.

Of course, these issues are still under discussion in crafting the IP Annex, so these remarks can only be taken as initial indication of a possible result.

## V. CONCLUSION

IP assets are an increasingly important component of the global economy. Effective utilization of IP assets requires states to address how these assets can be effectively used as collateral. Secured financing of IP assets allows parties the ability to obtain necessary financing to make new works of the mind, and allows existing enterprises to realize full value from their IP Assets. However, facilitating effective IP financing will require modernization of both secured financing law and IP law. UNCITRAL has already advanced the process of modernizing secured financing law, and is working to harmonize its innovations with IP law. The IP experts at WIPO, both government officials and private sector professionals, should welcome these advances and undertake fully to participate in the process.