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WORLD INTELLECTUAL PROPERTY ORGANIZATION
GENEVA

INFORMATION MEETING ON

INTELLECTUAL PROPERTY FINANCING

organized by
the World Intellectual Property Organization (WIPO)

Geneva, Switzerland, March 10, 2009

WIPO INFORMATION PAPER ON INTELLECTUAL PROPERTY FINANCING

prepared by the Secretariat

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[1] The opinions contained in this document are those of the contributors and not necessarily those of the Secretariat or of the Member States of WIPO.

INTRODUCTION

In the current uncertain economic times, intellectual property (IP) financing (the use of IP assets to gain access to finance) is of growing economic importance. Global commerce in the emerging IP asset class is worth an estimated US$300 billion worldwide annually, and a majority of corporate value today is represented by intangible assets. The financial potential of IP assets is currently limited, however, by systems and policies that are still largely geared to tangible assets.

IP financing occurs in many countries in a range of industries using a variety of financial mechanisms, but its level of success is based on legal and regulatory support, the awareness of the banking industry and development of capital markets. IP financing has great potential in developing countries, and particularly among small and medium-sized enterprises which rely upon their knowledge and IP assets as the main source of funding. In this context, IP financing can provide an accessible source of relatively inexpensive funding, and encourage further innovation and creativity. In many developing as well as developed countries, however, levels of awareness of IP assets-based financing remain low, and progress is needed to tap this potential. The issue is the subject of international policy development at the United Nations Commission on International Trade Law (UNCITRAL).

In response to a request by its Member States to provide information on the issue of IP financing, the World Intellectual Property Organization (WIPO) organized an Information Meeting on IP Financing, which took place at WIPO Headquarters on March 10, 2009[2]. The purpose of the WIPO Information Meeting was to raise awareness among Member States' copyright and industrial property offices, and the wider IP community, of the opportunities and challenges of IP financing by drawing attention to current practices in different countries and different industries, including in the copyright, patent and trademark fields. The Meeting also highlighted the ways in which improvements in law or financing practices could assist IP right holders to manage their IP assets for greater value, and thereby sought to assist Member States in setting-up appropriate national strategies in the field of IP.

This Information Paper on IP Financing draws contributions from the speakers at the WIPO Information Meeting, and provides further background on the practice of IP financing involving assets consisting of trademarks, patents, and copyright, as well as international and national policy developments in the area.

Questionnaire on IP Financing

Also in response to a request from Member States, in December 2008, WIPO conducted a questionnaire on IP financing, in order to gather information on provisions related to security interests in IP in national and regional IP and other laws. The results of the questionnaire are set out at Annex I.

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[2] The program and presentations given at the WIPO Information Meeting on IP Financing are available for download at *http://www.wipo.int/meetings/en/details.jsp?meeting_id=17582*.

CHAPTER I: INTERNATIONAL INTELLECTUAL PROPERTY FINANCING: AN OVERVIEW

By Mr. Lorin Brennan

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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[3] streamlines procedures filing patent applications, as well as licenses and security interests. The Singapore Treaty on the Law of Trademarks[4] 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[5]. These efforts demonstrate a firm commitment to developing modern legal rules, professional practices, and management systems for the global information economy.

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[6], the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards[7], and the U.N. Convention on the Use of Electronic Communications in International Contracts[8] which is pending ratification, among other important treaties.

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[3] At *http://www.wipo.int/treaties/en/ip/plt/index.html.*
[4] At *http://www.wipo.int/treaties/en/ip/singapore/*.
[5] See *http://www.wipo.int/ip-development/en/*.
[6] At *http://www.uncitral.org/uncitral/en/uncitral_texts/sale_goods.html*.
[7] At *http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention.html*.
[8] At *http://www.uncitral.org/uncitral/en/uncitral_texts/electronic_commerce/2005Convention.html*.

Similarly, the International Institute for the Unification of Private Law (UNIDROIT) has sponsored the Cape Town Convention on International Interests in Mobile Equipment[9] and promulgated a Model Law on Equipment Leasing[10] 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[11], and in 2008, it completed a Legislative Guide on Secured Transactions[12] (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[13]." 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[14]." 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[15]" (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 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.

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[9] At *http://www.unidroit.org/english/conventions/mobile-equipment/main.htm*.
[10] At *http://www.unidroit.org/english/documents/2008/study59a/s-59a-17-e.pdf*
[11] At *http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/2004Guide.html*
[12] See UNCITRAL Guide at *http://www.uncitral.org/uncitral/en/uncitral_texts/payments/Guide_securedtrans.html*. The text currently available on-line is subject to final editing.
[13] UNCITRAL Guide, para. 5.
[14] UNCITRAL Guide, Recommendation 4(b).
[15] See IP Annex at *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."

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[16]. 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[17]:

> *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 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 Banks 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.

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[16] See IP Annex, paras. 33 – 46, for further examples.
[17] This example is drawn from IP Annex, para. 42.

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:

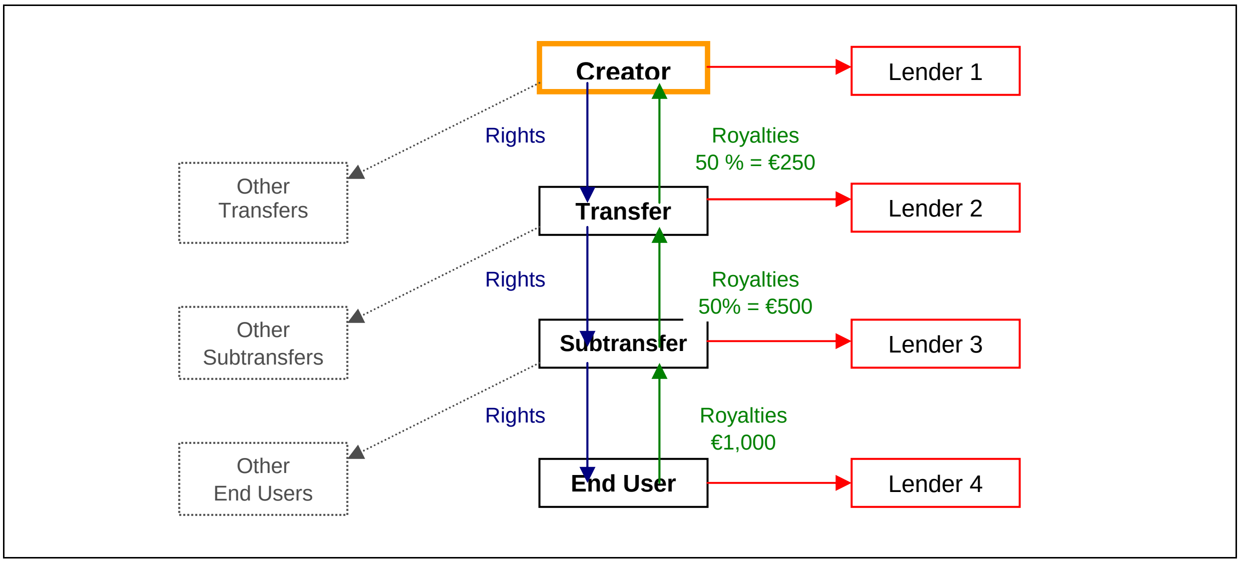

Figure 1: “Asset-Financing” Model

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[18]. 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.

[18] 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[19]. 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[20]:

[19] 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 IP licenses.

[20] 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:

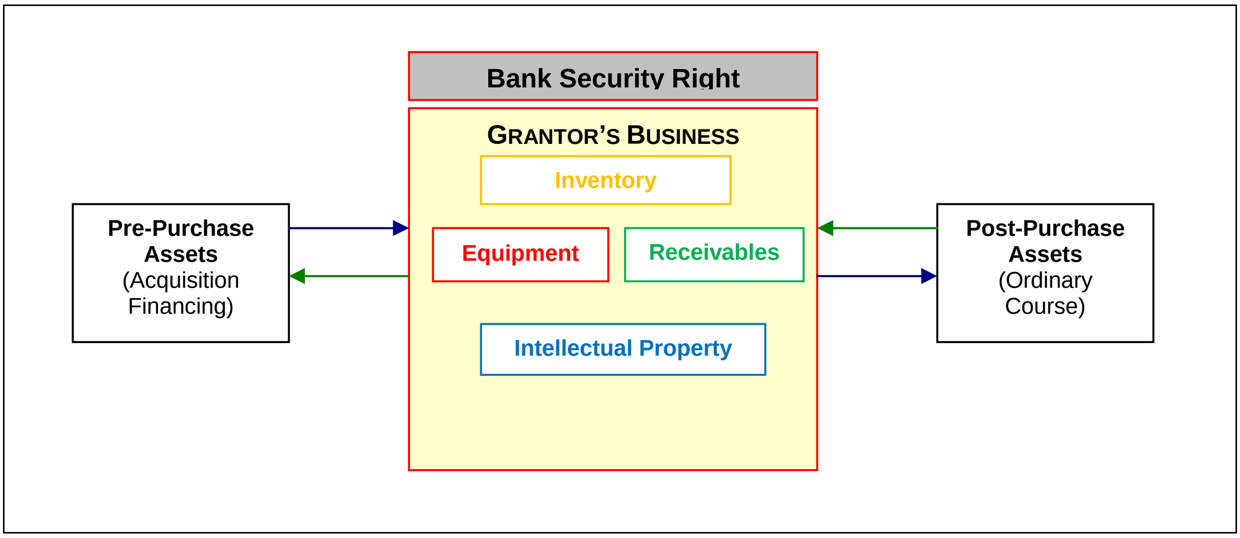

Figure 2: "Enterprise-Centric" Financing

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[21]. Functionally, this works as a substitute for a "retention of title" sale by an equipment seller[22]. 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[23], 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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[21] See UNCITRAL Guide, Commentary Part IX.
[22] 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.
[23] 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 item 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[24]. 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.

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[24] 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 of 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.

C. Contrasting Policies

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 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 coves 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 in 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[25].

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[26]. An effective secured financing law should accommodate both polices.

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[27]. Of course, intellectual *property* law must by definition differ from the property law for tangible commodities[28] 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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[25] 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.*

[26] 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.

[27] 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)."

[28] 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.*

This UNCITRAL Guide contains an extensive discussion of the historical approaches to security rights that have developed throughout the world[29]. 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: immoveable (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 – immoveable, tangible moveable, and pure intangible – but statutes drafted in earlier times do not say so explicitly[30]. 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.

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[29] See UNCITRAL Guide, Commentary, I.C. paras. 45-112.

[30] 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."

One approach was to extend the pledge by creating devices such as the "registered pledge" and "non-possessory pledge[31]." In order to provide notice of the financing, legislatures created public filing systems akin to those for immoveable 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[32]. 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[33], and account financiers[34]. 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."

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

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[31] See UNCITRAL Guide, Part I paras. 62-75 (discussing non-possessory financing devices).
[32] See UNCITRAL Guide, Part I paras. 85-100 (discussing approaches to use of title for security purposes).
[33] 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.")
[34] 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).

"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[35]. This is the approach in the UNCITRAL Guide[36].

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, although there often are adjustments in the effect effectiveness and priority rules. Thus, states that recognize "title-based" financing devices allow them to apply to IP[37]. Similarly, states that use "possession-based" financing devices make them available for IP financing as well[38]. 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[39]. 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[40]. 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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[35] See UNCITRAL Guide, Part I, paras. 25-29 discussing this development.

[36] See UNCITRAL Guide, Part I, paras. 30-31 discussing impact.

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

[38] See, for example, Melvin Simensky, Lanning Bryer & Neil J. Wilkof, *Intellectual Property Rights in the Global Markeplace* (2nd 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).

[39] 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 might change these rules.

[40] 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* (2nd ed. 1999), Chapter 59 Sweden 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[41] and Treaty on the International Registration of Audiovisual Works[42] 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)[43], the Paris Convention for the Protection of Industrial Property – Stockholm Act (Paris Convention)[44], and the Berne Convention for the Protection of Literary and Artistic Works – Paris Act (Berne Convention)[45]. 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[46]. As to copyright, TRIPS incorporates Art. 2(6) of the Berne Convention[47], 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[48]. 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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[41] Patent Law Treaty Art. 14(1)(b)(iii), at *http://www.wipo.int/treaties/en/ip/plt/index.html*.
[42] Film Registry Treaty at *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.
[43] At *http://www.wto.org/english/res_e/booksp_e/analytic_index_e/trips_e.htm* (Analytic Guide to TRIPS).
[44] At *http://www.wipo.int/treaties/en/ip/paris/index.html*.
[45] At *http://www.wipo.int/treaties/en/ip/berne/index.html*.
[46] 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."
[47] TRIPS Art. 9 provides: "Members shall comply with Articles 1 through 21 of the Berne Convention (1971) (except for Article 6*bis*)."
[48] 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 "rightsholders." 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 rightsholder[49].

In applying these principles, a seminal issue is whether a secured creditor qualifies as a "rightsholder." Secured financing law conceives of a security right as a type of property right in collateral[50]. 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[51]. Instead, a secured creditor obtains a special property right to exercise whatever right the grantor has to dispose of collateral in case of enforcement[52]. 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 law. The IP Annex[53] specifically dispels this notion as incorrect, and provides:

> "[T]he question of who is the owner (or lesser rightsholder) 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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[49] 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 rightsholder." 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."
[50] 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."
[51] 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 rightsholder) of the encumbered intellectual property (in other words, who is the owner or rightsholder) and the secured creditor does not become an owner (or lesser rightsholder) on the sole ground that it acquired a security right in intellectual property."
[52] See IP Annex para. 35.
[53] 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[54]. 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 "rightsholder") 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 "rightsholder" under the international conventions, especially TRIPS. This follows from three observations. First, TRIPS protections in Article 42 apply to "rightsholders" a term that is broader than "owner[55]." The term includes parties with legal standing to assert rights[56], and states often allow secured creditors to take legal action against infringers to protect the value of their IP collateral[57]. 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 "rightsholder" 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/rightsholder on foreclosure with priority over rightsholders without the secured creditor itself being a rightsholder. This would supersede the system of exclusive property rights accorded to rightsholders in TRIPS and other international conventions. Finally, if a secured creditor were not a "rightsholder" 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.

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

[54] See Melvin Simensky, Lanning Bryer & Neil J. Wilkof, *Intellectual Property in the Global Marketplace* (2nd 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*).
[55] Appellate Body Report, *United States – Section 211 Appropriations Act*, para. 217 states: "We agree with the Panel that the term 'rightsholders' 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 'rightsholders' 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*.
[56] TRIPS Art. 42, fn 11 provides: "For the purpose of this Part, the term "rightsholder" includes federations and associations having legal standing to assert such rights."
[57] See, for example, Mexican Industrial Property Law (*Ley de la Propiedad Industrial* of June 25, 1991, as amended).

proceeds in the form of receivables[58]. These royalty payment streams can also be financed as separate collateral[59]. The Guide does not decide the treatment of royalties for purposes of IP law[60]. 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[61]: "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[62], so that the ability to collect royalties is considered an essential part of the economic rights accorded to IP owners[63]. National IP statutes also recognize the rights to collect royalties as an essential component of IP rights[64], as do national courts[65].

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[58] 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."

[59] 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."

[60] 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."

[61] Understanding the WTO: TRIPS Agreement, at *http://www.wto.org/english/thewto_e/whatis_e/tif_e/agrm7_e.htm.*

[62] 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/disp_settlement_cbt_e/a1s1p1_e.htm*.

[63] 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).

[64] 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 an 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."

[65] For example, European Court of Justice, Judgment of 18 Mar. 1980, Case 62/79, *Procureur du Roi v. Marc Debauve 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. v.*

[Footnote continued on next page]

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 is 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[66]. 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[67]. As the Commentary explains[68]:

> "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

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[Footnote continued from previous page]

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."

[66] 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.

[67] 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 …"

[68] UNCITRAL Guide, Commentary Part I para. 56.

> 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[69]. 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[70]. For intangible assets, the security agreement must be signed by the parties[71]. It can cover both existing and later acquired ("future") assets of the grantor[72]. Once the security right is created it becomes enforceable between the parties themselves[73].
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> 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 describes the collateral in a general security rights registry proposed in the

[69] UNCITRAL Guide, Recommendation 13.
[70] 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…"
[71] 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.
[72] UNCITRAL Guide, Recommendation 13.
[73] UNCITRAL Guide, Recommendation 13.

Guide[74]. 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[75]. 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[76]. 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[77].

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[78]." 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[79]. 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[80]. However, a security right can remain effective in proceeds, such as receivables, from the sale or lease of collateral, with the same priority[81].

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[82]." 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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[74] 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.
[75] UNCITRAL Guide, Recommendation 76 (priority among competing claimants) and Commentary, Introduction para. 88 (containing definition of "competing claimant").
[76] UNCITRAL Guide, Recommendation 142.
[77] UNCITRAL Guide, Recommendation 208.
[78] See UNCITRAL Guide, Commentary Part II, para. 64-67.
[79] 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.
[80] 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.
[81] UNCITRAL Guide, Recommendation 100.
[82] UNICTRAL Guide, Commentary Part 1 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))[83]." However, Recommendation 4(b) is not a total exclusion of IP from the Guide. Rather, it is 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[84]."

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[85]." 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[86]." Also, the "law relating to intellectual property" is not limited solely to statutory enactments but includes "both statutory and non-statutory law[87]." 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[88]." 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[89]" 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.

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

[83] UCITRAL Guide, Commentary, Part I para. 33.
[84] UNCITRAL Guide, Commentary Part I para. 36.
[85] UNCITRAL Guide, Commentary Part I para. 88.
[86] IP Annex, para. 15.
[87] UNCITRAL Guide, Commentary Part I para. 88.
[88] IP Annex, para. 17.
[89] 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."

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[90]." 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, with its related effectiveness and priority rules. 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.

[90] 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[91]. 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[92]. 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[93].

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[94].

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[95]." One exception has to do with the assignability of certain receivables, which is discussed in the next section.

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[91] See UNCITRAL Guide, Part I para. 5.
[92] See UNCITRAL Guide, Part. I para. 6.
[93] See UNCITRAL Guide, Part I para. 8.
[94] See UNCITRAL Guide, Part I, para. 9.
[95] 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[96]. 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[97]. In some countries, the economic rights of authors may not be transferred for security, although proceeds may be[98]. Some countries allow a security right in a patent application before a patent is issued[99], while others do not[100]. It is often provided that licenses are not transferrable without the consent of the IP owner[101], although an exception is allowed in case the license is transferred as part of a transfer of the entire enterprise[102]. 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[103]. 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[104], subject of course to Recommendation 4(b).

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[96] See IP Annex, WP.37 Add. 1 paras. 60 -64, discussing issues.

[97] E.g. United Kingdom, Copyright, Designs and Patents Act 1988, 1988 Chpt. 48, Art. 95.

[98] *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."

[99] 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.")

[100] 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."

[101] See Germany Copyright Law (*Urheberrechstgesetz* 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."

[102] See Germany Copyright Law (*Urheberrechstgesetz*) 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.

[103] UNCITRAL Guide Recommendation 23; also IP Annex, WP.37 Add.1 para. 66.

[104] 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[105].

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 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[106].

For example, in the European Union, the Rental Directive[107] 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[108]. Administration of the right to equitable remuneration may be entrusted to a collecting society[109]. 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[110]. Similar restrictions apply to other levy schemes, such as for *droit de suite*, private copying, and 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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[105] See UNCITRAL Guide, Part II para. 105.
[106] See IP Annex, WP.37 Add. 1 para. 65.
[107] 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").
[108] Rental Directive Art. 4.
[109] Rental Directive Art. 4(3).
[110] 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[111]. For purposes here, the focus is on issues of effectiveness. Priority is discussed separately below.

[111] 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[112]. However, the Guide adopts the basic policy approach that a secured creditor must give appropriate notice of the financing to makes 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 of 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[113]. For example, if under a state's industrial property law the only way to make security right in a patent effective against third parties it 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[114]. 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[115]. 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[116]. This encourages use of the specialized registry to for a secured creditor to achieve "maximum protection."

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112 UNCITRAL Guide, Recommendation 13.

113 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").

114 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)."

115 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."

116 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

[Footnote continued on next page]

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[117]. 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.

[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."

[117] 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[118]") may also need to file a notice to make its claim to royalties effective against third parties[119]. 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 fosters 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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[118] 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."

[119] 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 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[120], but Recommendation 65 leaves it for states to pick when lapse occurs[121]. The Guide has three choices[122]: (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[123]. 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[124]." 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.

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[120] 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."

[121] UNCITRAL Guide, Recommendation 65 provides: "The law should address the impact of a transfer of an encumbered asset on the effectiveness of registration."

[122] UNCITRAL Guide, Commentary Part IV para. 78-80.

[123] IP Annex Add. 2 para. 30-36.

[124] UNCITRAL Guide, Commentary Part IV para. 75.

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 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[125] 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))[126]."

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[127]. In that

[125] UNCITRAL Guide, Recommendation 81.
[126] IP Annex para. 48.
[127] IP Annex, para. 48.

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 fling in a specialized IP registry.

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[128]. Knowledge of the other security right does not affect priority[129]. 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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[128] IP Annex, para. 50.

[129] 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[130]. Again, knowledge of a prior security right does not affect priority[131].

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[132], 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[133].

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[134]. This issue is still under consideration in the IP Annex.

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[130] 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."
[131] 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."
[132] See UNCITRAL Guide, Commentary, Part V, paras. 46-50.
[133] See UNCITRAL Guide, Commentary, Part V para. 47 (the basis for the example in the text).
[134] 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[135]. Other countries allow for the filing of security rights in the registry, but do not provide an express priority rule[136], or only provide that the filing is presumptive evidence of validity[137]. 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[138]. 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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135 *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 ..."
136 *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).
137 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.")
138 E.g. Brazil, Law No. 9,279 of May 14, 1996, Art. !30(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

[Footnote continued on next page]

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[139]. 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[140]." In other cases, the IP law allows for an "assignment" of the IP and provides that such an assignment is ineffective if not registered[141], but application to security rights is unspecified. In these cases, the priority rules in the IP statutes will apply in lien of those in the Guide, although in the last mentioned case a clarification would be in order.

[Footnote continued from previous page]

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 …")

[139] *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.)

[140] 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).

[141] 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 purchase3r 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[142]. 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[143]. 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 casution 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[144]. 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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[142] 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."

[143] 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);

[144] 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[145] rules for an efficient secured transaction regime should be easy to determine, certain in application, predictable in result, and match commercial expectations[146]. 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[147]. 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[148].

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[149]." 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[150]." Intangible assets include receivables[151]. 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[152]."

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[145] 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.

[146] 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).

[147] 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 …"

[148] 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."

[149] UNCITRAL Guide, Recommendation 208.

[150] UNCITRAL Guide, Recommendation 218(b).

[151] UNCITRAL Guide, Commentary Part X, para. 41.

[152] 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[153]: "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[154]. It currently proposes three alternatives for discussion[155]:

> *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.

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

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[153] UNCITRAL Guide, Commentary Part X, para. 42.
[154] IP Annex, Part X.
[155] IP Annex, Part X para. 20.

“rightsholder” 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.

CHAPTER II: INTELLECTUAL PROPERTY FINANCING IN THE FIELD OF TRADEMARKS: A MALAYSIAN PERSPECTIVE

By Mr. Jern Ern Chuah

In considering the topic of intellectual property (IP) financing in the field of trademarks, it is important to establish some background facts such as an overview of Malaysia and its economy, its position in relation to IP, the present trademark regime in Malaysia and the advent of local trademarks as well as an overview of the financial services regime in Malaysia. These will be covered in brief, before a consideration of the present position in Malaysia involving IP financing in the field of trademarks.

A Brief Overview of Malaysia and its Economy[156]

Malaysia is a relatively small country (with a landmass of approximately 330,000 km² and around 27 million people) nestled in the centre of South East Asia. It is divided into two separate regions, Peninsular Malaysia and East Malaysia (located on the island of Borneo) and has as amongst its neighbours the more well-known countries of Thailand, Indonesia, Singapore and the Philippines.

A fairly new country (Malaysia as a full federation of 13 states and three federal territories only came into existence in 1963), it is nevertheless a fast growing and developing country. Extremely rapid development in the 1980s and early to mid 1990s (pre-Asian financial crisis) led Malaysia from being a third world country to being considered a newly industrialized country (or second world, so to speak).

Malaysia falls within the top 30 largest economies in the world with GDP in 2007, being around USD360 billion and GDP growth normally being in the 5-7% bracket in recent years (GDP growth in 2008 was only at 4.6%, due to a very sharp slowdown in the 4th quarter).

Malaysia has a fairly open business environment and ranks within the top 25 countries in the world in terms of ease of doing business. An export-oriented country, Malaysia's largest trading partners include the United States, Germany and Japan. The majority of businesses in Malaysia (around 91% of all industrial establishments) are considered small to medium-size industries and enterprises (SMI-SME); *i.e.* each with a turnover of less than RM25 million and having a workforce of less than 150 workers.

Private enterprise and ownership is very much promoted in the country, though on a separate count, the government greatly influences the country's economic direction through development plans (the Malaysian Plan, currently in its 9th iteration) and large government run organizations such as the Economic Planning Unit, in addition to government-linked investment entities and wealth funds such as the Employees Provident Fund and Khazanah Nasional Berhad.

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[156] Economic numbers and statistics were obtained from Bank Negara Malaysia (*www.bnm.giv.my*), the Department of Statistics Malaysia (*www.statistics.gov.my/eng/*) and the Economist magazine's website (*www.Economist.com*).

The Malaysian Plans are targeted towards accelerating the growth of specific sectors and industries, thus resulting in overall expansion of the Malaysian economy. The 9th Malaysian Plan heavily focuses on agriculture (and the advent and development of a biotechnology industry in Malaysia), the service industry and in high end manufacturing requiring specialized skills. To bolster this, Malaysia has, amongst other things, developed a National Intellectual Property Policy and has set up a fund in support of the same.

The National Intellectual Property Policy (NIPP)[157]

The National Intellectual Property Policy was launched in April 2007, and has as its main purpose the harnessing of IP as a new engine of growth for the enhancement of economic and social prosperity in Malaysia. It recognizes that managing and harnessing IP strategically is necessary to enhance Malaysia's long-term competitiveness and to place Malaysia squarely as a knowledge-based economy.

The originating intention of the NIPP was to facilitate the formation of an environment that stimulates and fosters the creation, protection, enforcement, management and maximum exploitation of IP. It is aimed ultimately at developing a vibrant IP industry as a future driver of growth in the country and has set the target of five years towards achieving the same.

Amongst the eight key objectives of the NIPP is the promotion of IP-generated activities, which in turn necessitates the creation of a conducive environment that provides incentives, grants, management, finance, business transactions, enforcement and proper dispute settlement regimes.

Bearing that in mind, the NIPP provides for the development of a proper financial infrastructure for IP transactions, including the promotion of suitable valuation methods, contractual and licensing rules to facilitate commercial exploitation of IP, all of which is at the time of writing under review by the authorities.

The NIPP recognizes that the necessary development of a proper IP financial infrastructure will require the following:

(a) the review of current laws and regulations in company law, securities regulations as well as banking and finance law in general to ensure that business, banking and financial infrastructure in Malaysia can support IP-based transactions;

(b) encouraging the banking and finance sector to develop IP-based banking and financial instruments for the mortgaging of IP assets and the use of IP as collateral and security;

(c) the creation of an IP exchange or marketplace to stimulate the trading of IP and to develop a more liquid market for IP trading; and

[157] Information on the NIPP was obtained from the Perbadanan Harta Intelek Malaysia (MyIPO) from its website at *www.mipc.gov.my*.

(d) the review of existing laws and business practices with a view to enhancing the business climate for financing IP based investments including the setting up of a specialized IP Financing house.

To ensure that the NIPP is properly implemented, the Malaysian Treasury has allocated a fund of RM5 billion (approximately USD1.47 billion) specifically for the purpose of promoting the growth of IP. It is expected that a specific allocation will be reserved for the development of an IP financial infrastructure, though this is likely to happen only in the latter to end stages of the NIPP's implementation, which would be in 2011 leading to 2012.

The local trademark scene and Malaysian trademark owners[158]

Although the possibility of securing trademark protection in Malaysia arose well before Malaysian independence (protection in the territory of Malaya (Peninsular Malaysia), Sabah and Sarawak arose during the days of British colonial rule through an extension/re-registration system of British filed trademarks), the present Malaysian regime of trademark protection had its beginning in 1983, and is therefore fairly young.

Despite various amendments over the years, the Malaysian trademark position can be considered fairly conservative, and at present has no specific provisions which allow for the specific use and recordation of IP as an asset in a financial transaction, apart from the assignment of the same. In fact, it is still the case that notice of a trust, whether express, implied or constructive, cannot be entered in the Register of Trade Marks nor can even be received by the Registrar[159].

It is also the case that local ownership of trademarks lags behind that of foreign ownership, though this is not likely to be the case in the longer term. The government undertook initiatives to increase IP awareness amongst local companies in the late 1990s, and early 2000s, to date and this has in fact borne fruit in that there is a much larger volume of local trademark filings since 2004. In fact, the preferred local parity position of 50% of total filings is almost reached every year since 2002, and in fact exceeded by a small margin in 2004. Trademarks comprise the largest segment of registrable IP rights in Malaysia. In fact, there is a larger volume of trademarks filed in Malaysia than all the other forms of registrable IP combined.

Registration and ownership of trademarks however is still very much weighed toward foreign proprietorship by a ratio of almost 2.5:1, but this is predominantly due to the application cycle in Malaysia which approximates three years. It is anticipated that in the years to come, one would again start to approach parity between local and foreign ownership of trademarks, which would, in part, mirror the application statistics. One caveat to this would be the unfortunate fact that local applicants are more likely to abandon trademark applications when faced with queries or initial objections raised by the Trademark Examiners, due predominantly to the mistaken belief that such objections cannot be challenged. Foreign applicants are however more likely to stay the course of the application until a final rejection is issued.

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[158] Statistics and numbers on trademarks were obtained from the Perbadanan Harta Intelek Malaysia (MyIPO).
[159] Section 7, Malaysian Trade Marks Act, 1976.

At present, out of 184,612 registered trademarks, 52,860 are held by locals and these form the small yet possible pool in which one is likely to come across in local IP financing.

Application and Registration of Trade Marks From 1983 to 2008

Year	Application			Registration		
	Malaysia	Foreign	Total	Malaysia	Foreign	Total
1983-1999	77,415	99,122	176,537	14,037	46,371	60,408
2000	6,303	12,500	18,803	449	1,328	1,777
2001	6,525	10,078	16,603	1,570	5,341	6,911
2002	7,661	8,785	16,446	4,056	7,072	11,128
2003	8,327	9,439	17,766	3,014	9,108	12,122
2004	10,406	10,337	20,743	3,243	8,473	11,716
2005	10,479	11,668	22,147	3,683	7,771	11,454
2006	11,209	12,840	24,049	5,651	10,108	15,759
2007	12,289	13,605	25,894	8,108	17,382	25,490
2008	12,562	13,472	26,034	9,049	18,798	27,847
Total	**163,176**	**201,846**	**365,022**	**52,860**	**131,752**	**184,612**

Statistics Obtained from Intellectual Property Corporation of Malaysia (MyIPO)

A brief overview of financing in Malaysia

The financial services industry in Malaysia is somewhat varied. With the majority of businesses being SMI-SMEs, the largest role in financing in Malaysia is unregulated, and is actually provided by family and friends. As these often arise by oral contracts and understandings, and much is unrecorded, we will not dwell on this though it is important to note that much of what is considered to be financing that takes place in Malaysia is loose and unregulated.

Banks provide the next echelon in the financial services strata and the banking industry in Malaysia is considered to be very conservative and prudent with a reasonably strict credit culture. Banks can either provide direct financing or work through various government linked or private networks. Bank backed private investment operations and bank-government backed venture initiatives undertake financing activities through, amongst others, the following:

– helping high level private investors match investments with interested parties;
– the creation of private equity concerns by creating a group based investment fund of high net-worth individuals; and
– partnering with credible venture capital companies from overseas.

Venture arms form the next level in the financing industry. These may be private, bank backed or Government-backed concerns. Securitization practices if and when they arise, would more often than not arise under the auspices of the venture arms.

Government and government-backed grants and incentives form the last major role in financing commercial concerns. These grants provide either direct funds to entrepreneurs or offer tax incentives to IP creators and those involved in the field of emerging and early stage technology. Malaysia provides various incentives and grants through various Ministries and government linked Statutory Bodies such as the Multimedia Development Corporation and Malaysian Biotechnology Corporation.

IP financing in the field of trademarks in Malaysia: grants, collateral and securitization[160]

IP financing in the field of trademarks in Malaysia is well in its infancy, and is not yet developed. The standing rule tends to be that the focus will be in the underlying business rather than on the trademarks by itself. Venture arms tend not to focus on trademarks per se, preferring to focus on what they consider to be viable businesses where the trademark is only of secondary importance and is at best an ancillary interest covered under wide-ranging control issues. When it comes to venture arms, the field of financing technology-related concerns is more developed than that of trademark financing.

The primary means of recognized external financing for trademarks in Malaysia comes through Government and Government-backed grants. We will consider two such grants which are specifically targeted towards trademarks.

(i) The first is from Malaysia's national trade promotion agency MATRADE (Malaysia External Trade Development Corporation). MATRADE provides Brand Promotion Grants for the development of local brands outside Malaysia as well as to help companies invest in developing a brand strategy for their products and services. The grant which operates on a reimbursable basis, assists companies develop, promote and manage their respective brands in order to ensure that the brand is well positioned in the overseas market and contribute towards developing the image of the country as a reliable supplier of quality brands.

Not all trademarks are eligible, however. The Brand Promotion Grant will only be granted to eligible marks identified by the Brand Grant Committee (Approval Committee) and there is a steep evaluation based on various considerations including:

- the company's branding strategy and plans;
- its business and marketing plans;
- identified resources invested by the company on branding and its commitment to the branding program;
- previous and intended activities undertaken to promote the brand;
- positive trends in overall sales and exports over past three years;
- the brand's market share in both local and overseas markets;
- the potential for the brand to further expand in the international market;
- how the brand will help project Malaysia's image as supplier of quality products and services.

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[160] Information on MATRADE's Brand Promotion Grant were obtained from *www.matrade.gov.my* and MSC Malaysia's IPGS from *www.mscmalaysia.my/topic/IP+Grant+Scheme*.

The amount of the grant is considered to be fairly generous by Malaysian standards. For larger companies, there is a 50% reimbursable grant of up to a maximum of RM2 million per company per brand, and for SMI-SME companies, there is an option of either a 100% reimbursable grant of up to a maximum of RM1 million per company per brand or a combination of the above-mentioned 100% reimbursable grant and the 50% reimbursable grants with a maximum grant of RM 2 million per company per brand.

(ii) The second applies more directly to trademarks but has a more limited audience. MSC Malaysia, an initiative to springboard Malaysia through ICT into a knowledge-based economy driven by a knowledge society, provides specific grants related to IP, including trademarks to help defray some of the costs incurred in obtaining IP protection.

These grants (known as the IP Grant Scheme) are managed by MDeC, the Multimedia Development Corporation, which oversees and manages MSC Malaysia initiatives via industry and capacity building and socio-economic developments. The IP Grant Scheme provides funding to help MSC Malaysia status companies protect and capitalize on their IP. It is only open to local MSC Malaysia Status companies (characterized as having 51% or more equity owned by Malaysians) and is designed to subsidize up to 70% of the initial costs incurred for filing applications to register trademarks and other registrable IP rights.

The grants provide reimbursable sums of up to RM17, 500 per applicant per annum, and apply to both local and international filing of trademarks. Despite the relatively small sums on offer here compared with other grants, there are also much fewer restrictions and requirements as compared with other grants.

What is considered to be the more traditional understanding of IP financing, i.e. transactions with a bank where IP is used as the sole collateral in support of a loan, is almost unheard of in Malaysia at present. As earlier mentioned, the banking industry in Malaysia is considered very conservative and prudent with a strict credit culture and whilst there are no specific limitations to trademarks being used as collateral, the actual acceptance of a trademark as sole collateral is almost unknown. It is also a known fact that in the vast majority of corporate loans, the local banks would require at the very least a corporate guarantee, failing which a loan would likely not be considered at all. With this regime in place, there is very little place for a trademark to be considered as sole collateral. As part of a larger collateral base, a trademark would automatically be included.

There is no single reason for the lack of use of trademarks as sole collateral but one can surmise that this is due to a confluence of specific factors, including:

– the lack of awareness of IP in the local banking industry and the reluctance to accept intangible assets except as part of a larger collateral base;

– the conservative nature of the banks in Malaysia, and the fact that the banks do not have sufficient manpower to execute non-traditional sales;

– the presently illiquid nature of trademarks as an asset and the lack of a local marketplace for the trading of IP;

– the large discounts in the determination of value and in loan figures which make it pointless for trademarks to be considered as sufficient collateral to stand by itself;

- that there is no real history of transactions for the purpose of establishing proper trademark valuation, nor are there sufficient local resources and experts providing such valuations in Malaysia which would be accepted by the banks;

- the high cost of trademark valuations which are obtained overseas;

- the relatively small pool of local trademarks to draw from (numbering under 53,000 only) and the relatively new pool of local trademark owners most of which are SMI-SMEs with trademarks that are also fairly new and not yet properly established in the local and foreign marketplace;

- the lack of a proper infrastructure for the recordation of trademarks as collateral and security; and

- the ease in the near past of obtaining easy offshore financing.

It is hoped that the NIPP will go some way towards removing some of these obstacles but this is not envisioned in the very short run, though in the medium term this is very much possible, as both political and commercial will is presently focused and applied on this issue. The final known route for IP financing in Malaysia comes through the securitization of trademarks, which is customized, complex and again, limits itself to only a select few brands and companies. Though considered as an outsider in place of other preferred financial instruments, due to the lack of options in Malaysia for the raising of financing via trademarks and other IPs, it has been applied in various instances.

Trademarks would be considered to be somewhat suitable to secure debt as against itself, as they are specific assets recognized and derived from clear laws that are transparently and easily enforceable; have cash flows that can quite easily be attributed to it, have value should a distressed sale occur and are easily separable from the underlying business.

This is especially applicable for medium-sized companies which have a pool of known trademarks established in the local market. Though each and every such securitization is unique, fairly traditional pathways are followed. Not much is written or recorded of such transactions; as such securitizations are open mainly to private rather than public investors.

A glimpse into the future…

Taking into account the Government initiatives in Malaysia to grow it into a knowledge-based economy, its education and awareness programs, its incentives for the growth of local IP as well as the political will through the NIPP to grow IP, once can surmise that Malaysia stands on the cusp of a significant upsurge of IP backed activities including IP-related financing. Furthermore, with trademarks being the largest segment of registered IP in Malaysia and encompassing the largest ownership base, it would flow that trademarks will be taking a lead role in IP financing.

In a way, with as much focus as it has provided towards the development of local IP ownership, it would be impossible in the long run for Malaysia not to evolve its financing regime to take IP into account. It would be unwise for any country to ask its citizenry to develop and invest in IP, without then giving them an opportunity to leverage finances based on those investments. From a macroeconomic perspective, the country cannot afford for its citizenry to ignore the creation and development of IP assets, as IP has been proven to drive economic, social and cultural welfare.

On the other end of the spectrum, at the microeconomic level businesses and entrepreneurs also need to pay attention to IP as it is a key driver of business. They cannot afford to ignore IP in the medium to long term. However, with increased competition and dwindling credit resources affecting everyone with Malaysia being no exception, the need to convert IP assets from an unnoticed asset to a front-runner in terms of security and collateral is critical.

In meeting the objectives of the NIPP especially in the area of IP-based financing, the Government and its related development agencies must take advantage of their position to champion and promote private sector initiatives. They can and should kick-start the process, by acting as intermediaries and offering support and insurance-based services, as well as provide information towards communicating trust in the marketplace.

The promotion of an IP-savvy investment culture will help raise awareness of the value of IP among owners, investors and borrowers. Local bank and accounting bodies must be included as important and primary stakeholders in this exercise and they need to understand and not fear IP assets. Understanding their potential for wealth and value creation would lead to a better understanding of how best to value such assets.

As a natural corollary, we must also have a smooth and proper institutional framework for securing IP protection. Where Malaysia excels is in ensuring that IP protection is affordable. Recent studies[161] have shown that Malaysia is one of the, if not the cheapest jurisdiction in world to obtain IP protection. Where we can improve is in strengthening the local IP office in its reliability and shortening the duration in securing IP.

But the fundamental requirement to ensure a smooth creation of an IP financing regime in Malaysia is to alter the perception and conservatism of the local banks that IP, and trademarks in particular, cannot form the basis of “safe” collateral. This requires an across the board development of a proper IP financing infrastructure as proposed under the NIPP. While the political will to do so at a strategic level presently exists, the key issue of how to achieve this tactically remains unanswered. Much therefore hangs on how Malaysia takes into account similar reforms undertaken in other Asian countries such as Thailand, India, Singapore and Indonesia, and whether it intends to take on board into its local laws international initiatives such as UNCITRAL’s Legislative Guide on Secured Transactions and in particular its Annex specific to security rights in IP.

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[161] Information obtained from MDeC’s publication MSC Malaysia IP Guide.

CHAPTER III: INTELLECTUAL PROPERTY FINANCING IN THE FIELD OF PATENTS – THE USE OF PATENTS AS A TOOL FOR ACCESS FOR FUTURE FINANCING: THE HEBREW UNIVERSITY OF JERUSALEM'S PERSPECTIVE

By Ms. Renee Ben-Israel

Introduction

There seems to be no discussion on the role of intellectual property ('IP') as an asset in the contemporary knowledge-based commercial scenario. IP became an important topic in due diligence processes performed in commercial transactions; IP is an important item in the evaluation of companies, in measuring the development index of countries and is incorporated in the general ranking of technology transfer activity of academic institutions.

The increase in patent filing activity of universities is often considered as an indicator of the changing relationship between universities and their social and economic environment. In fact, the social and economic impact of the use of academic innovations goes far beyond the increase in the awareness of protection of IP rights by universities' researchers and their administrations. However, while the use of patenting as the entrance ticket for the business world and the means for recruiting funds for research is widely spreading, there could be some problems associated with it.

IP protection alone – disconnected from a supporting infra-structure provided by governments and industrial/commercial parties working strategically with academic and scientific research institutions (known as the Triple Helix) – has little chances of success. The purpose of this paper is to depict the peculiarities of university patenting focusing in the Israeli technological environment, Israel academic institutions and their technology transfer companies, and using my own company (Yissum) as a case study.

Patent Rights

Patent rights may be used in different ways; some classical patent strategies are defensive, dominating and licensing (in/out/cross-licensing):

(i) defensive: typically used by individuals/companies that have no intention of carrying out the development of the invention or using it themselves, and are mostly interested in preventing others from doing so;

(ii) dominating: contrary to the defensive strategy, this strategy is used by the producers, the ones that plan to use the technology or processes described in their patents, and to sue infringing parties. It suits companies/institutions where the invention is often an enabling platform patent and it is their core value, even if sometimes they plan to license out specific applications of the same platform;

(iii) licensing: remains one of the preferred ways of using patent rights, by both producers and non-producers. By licensing-out patent rights, people and institutions that do not intend to manufacture the invention may transfer the development, production and possible litigation to a third party while keeping some control over the patent. By licensing-in patent rights, a company may enhance its value, in the cases when it does not necessarily have the human resources or facilities to create the patents itself. Also, companies may file patents expecting them to work to their advantage in cross-licensing arrangements when complementary technology is needed; that is often the case in the production of sophisticated products. It is also useful in cases when one owns a broad platform patent and wishes to partially license specific applications.

Other: profit centers, for example

Some companies are mainly focused on proactive strategies of creating additional revenue for the organization by the use of the IP that is not available to competing parties. There are also “trolls”: “a term coined in the late 1990s by Peter Detkin, to refer to patent owners who hide under bridges they did not build to pop out and demand money from surprised passers-by” (M A Lemley, *Are Universities Patent Trolls?*). Lemley poses this provocative question in the above-mentioned article to elucidate the topic of good and bad patent owners (and no, he concludes that although universities may behave sometimes as bad actors, they are not trolls by definition).

1. Universities and IP

Universities are an odd player in the IP scene. The primary mission of universities (and research institutions in general) is to create knowledge through research and to transfer that knowledge to others through publications and teaching. Inventions, IP and their eventual transfer to commercial avenues are usually considered a by-product of the main line of activity of such an institution. Even though the results may be significantly rewarding to some universities, the main objective behind the technology transfer activity is the vision of a return of the public investment for the benefit of the public.

Universities are a unique case, since despite being neither producers nor manufacturers they are, nevertheless, increasingly filing patents. In most cases, they will not do it directly, but through the intermediary of their Technology Transfer offices, responsible for identifying the potential commercial value of the research results and of converting them into marketable tools (most universities today have such offices). Since the majority of the research results are of technological nature, technology transfer offices mostly rely on patents as their main IP tool.

Regarding strategies, universities cannot be classified as defensive or dominating filers. Although modern universities may sometimes be aggressive patent filers, it is usually due to their specific characteristics (the need for publication) and not as a result of a planned strategy.

Another characteristic of universities filing activity is that it is not market-driven; universities file what they are presented by their researchers and, in general, universities technology offices are not allowed to interfere in the academic freedom of their researchers. They will, therefore, typically behave as “technology pushers” instead of being “market pulled”. Also, given their role in basic research, their patents will often be the ones that provide the building blocks for industry and technology innovations.

However, the need to publish scientific results will lead to many premature applications; researchers often considering it as ‘just’ another paper or a grant proposal, overlooking its true value of being a key to the commercial world.

It will be the task of the Technology Transfer offices to guide the researchers and make the best out of their inventions, even when those inventions are in an embryonic stage.

Although many universities do engage in spin-off creation activity, the preferred way of commercialization will generally be the licensing-out; in many cases they will prefer exclusive licensing at early stages, since on the one hand they do not have the facilities or skills for product development and manufacture, and on the other hand they cannot afford the high costs of patent protection in a large scope. This situation is particularly true with the pharmaceutical development where the investment costs involved in the development are so high and the results so risky that the licencee will require exclusivity for entering such a venture.

This scene is changing though. The last AUTM (*Association of University Technology Managers) Licensing Survey (2007)* indicates a new tendency, namely of an increase in non-exclusive licensing.

Table US-9. Licenses Executed by U.S. Respondents in 2007: Exclusive vs. Nonexclusive

		Licenses and Options Executed				
FY 2007	**Number of Respondents**	**Total Executed**	**Exclusive**	**Exclusive % of Total**	**Nonexclusive**	**Nonexclusive % of Total**
U.S. Universities	161	3,784	1,619	43%	2,165	57%
U.S. Hospitals & Research Institutions	32	593	186	31%	407	69%
Technology Investment Firms	1	14	0	0%	14	100%
All U.S. Respondents	194	4,391	1,805		2,586	

Source: AUTM Licensing Activity Survey, FY 2007

This leads to the problem of patent financing, but from the applicant's perspective. The problem with patents, and particularly with university patents, is that it is hard to draw a clear line between expenses and revenues. One may invest large sums in the protection of his/her invention, and yet the commercial return will be negative. University patents will typically be early stage, premature inventions for basic scientific results, basic platforms, and in most cases, will not protect the final product in the market. This situation is aggravated in a country like Israel, with a small population and a constant need to seek external markets for its inventions. For this reason patents have to be filed abroad: the PCT filing is broadly used and National Phase entries expand to an average of four or five countries in the academic environment and at a larger scope at the industrial one. This operation is very onerous to Technology Transfer offices, with budget constraints often leading to losses in the commercialization process.

In addition, national patent offices are currently stricter in granting patents, examinations rounds are becoming tougher and, therefore, an application owner needs to hire highly qualified (and expensive!) professionals in order to overcome Examiners' rejections.

Finally, there is the uncertainty of the patent life cycle. One cannot predict the final costs of a filed application until it gets the final granting. And even then, there is always the possibility of facing oppositions, interferences and other costly troubles.

As mentioned, in the university environment where the applications filed are far from protecting or even envisaging the final product and its potential revenues, this may be a rather risky investment.

Due diligence IP processes performed by licencees may require some warranties to the licensed patents but this request is usually denied by the university licensor.

University patents are essentially meant to support Technology Transfer activity. So far, results are quite impressive. The last AUTM survey reports some millionaire universities and many others that have been doing quite well in Canada and the US. Israel has a Tech Transfer company in each of its universities, as well as in hospitals and other research institutions, two of them (Yissum among them) with very significant figures.

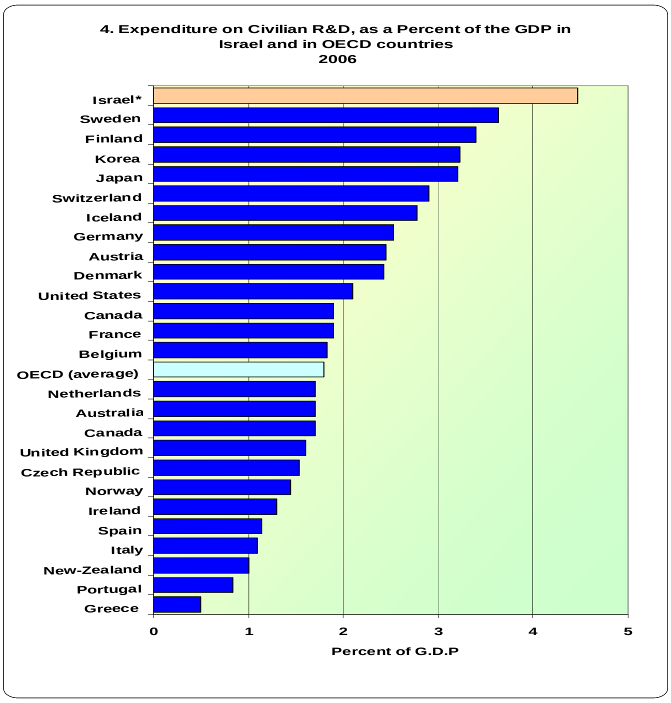
However, it is not only a question of money. An aspect that should not be disregarded of universities patent filing as a mean for technology transfer is the peripheral impact it has achieved over the years. The number of new projects, of new companies and of jobs created, the social and environmental impact, would not be possible without Tech Transfer activity.

Tech Transfer activity has also been successful in keeping good and prolific researchers in the academia by providing them new challenges and opportunities.

And finally, by filing patents and licensing them to industry, universities get a leverage position that allows them to promote global social responsibility, by requesting from their licencees special concessions for less developed countries, for humanitarian purposes, for research, etc. A whole trend is currently under way on this sense, e.g. AUTM Better World Project (*http://www.betterworldproject.org*); Med4all (*http://www.med4all.org/*) among others.

2. Technology, patents and Israel

As you may know, Israel is a small country in the Middle East, with a population of about seven million people, with a small territory and little natural resources. On the other hand, Israel has excellence in science, engineering and computation of international competitive level. Even before the foundation of the formal state of Israel, the country has absorbed groups of immigrant professionals in its scientific institutions and strived to create suitable frameworks to incorporate their technological skills. Hence, the transfer of knowledge from brain to institution and further on to its incorporation in society has always been part of its tradition.



4. Expenditure on Civilian R&D, as a Percent of the GDP in Israel and in OECD countries 2006

From its foundation in 1948, R&D has always been allocated a high percentage of the budget and despite all recent budget cuts it's still higher than in every other developed industrialized OECD member – 4.5% on civilian

R&D as a percentage of the GDP for 2006 in Israel and 4.7% in 2007 (source: The Central Bureau of Statistics, Israel, *National Expenditure on Civilian R&D, 2007,* 18/08/2008).

In a way, it does not come as a surprise. According to an urban legend, the state of Israel owes its creation to technology transfer.

The story tells that Dr. Chaim Weizmann, a chemist from Manchester University, was responsible for the first technology transfer in Israel. During WWI he developed a new process for the production of Acetone, a key component in the manufacture of explosives, patented it and presented it to the British Navy, and was appointed the position of head of the research laboratory with the assignment of finding an alternative, cheaper way of Acetone production. He developed a new and efficient biochemical process of Acetone production from plant fermentation by the isolation of the bacterium called *Clostridium acetobutylicum Weizmann* after the inventor. Weizmann refused to receive financial compensation from the British government since he considered his work as part of the British war effort. However, in 1917, he prompted the British government to issue the Balfour Declaration, the first legal document supporting the establishment of the state of Israel.

Whether the story is true or not, we don't know. But Dr Chaim Weizmann was elected the first President of Israel in 1949, kept his lab active while serving a President and in 1959, the Weizmann Institute launched its Technology Transfer company (Yeda) followed by the Hebrew University in 1964. Israel may thus be considered one of the pioneers in the identification of the value of its brain power as a fuel to its economic growth using the technology transfer activity from its universities and research institutions to the benefit of the state and the society at large.

Another true (and sad) fact that may also serve as an indicator of this focus on the transfer of scientific research to the development of new technologies is Israel's delicate political situation. Israel has been from its first days in a constant state of belligerence with its neighbours. In order to cope with its numeric inferiority, the state had to seek technological superiority. This is a worldwide known phenomenon and Israel is not alone in using it. We are all aware of the by-product developments that benefit society which result from state investments in military research: from atomic research to the Internet.

Finally, we cannot forget the entrepreneurial character of the population. Whether it has to do with its historical background or with other elements, this is a true characteristic of the Israeli population.

The process has been very fast. If in the 1950's, 48% of the state exports were agricultural goods, today Israel is a manufacturing-based economy dominated by high-tech industries. Israeli university graduates have given the world a range of innovations, including Intel microprocessors, the first worldwide Internet messaging service, and the security code that lies behind most of the world's computerized banking transactions. Intel, Microsoft, IBM, and Google have major research-and-development centres in Israel.
Patents are widely used; example:

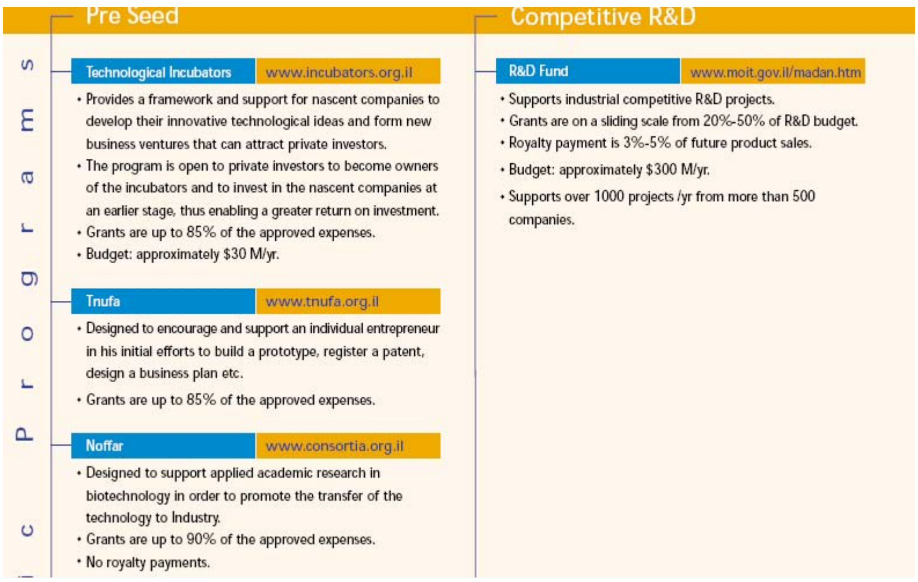
OECD: Israel has the highest percentage of patents in the region: Israel is ranked no. 6 globally for patents per GDP and 8th for patents per capita. In the OECD's Compendium of Patent Statistics 2006, Israel is ahead of OECD average in both ratios: it has 2.3 patents per billion dollars of GDP and 53.1 patents per million inhabitants.

3. Israel: Supporting Infrastructure:

Understanding that brain power and inventions need a supporting environment in order to develop, the State has strategically created incubators, incentive funds and frameworks to further cultivate its scientific achievements. There are several frameworks of this type throughout the country, some with programmes specifically designed for basic research.

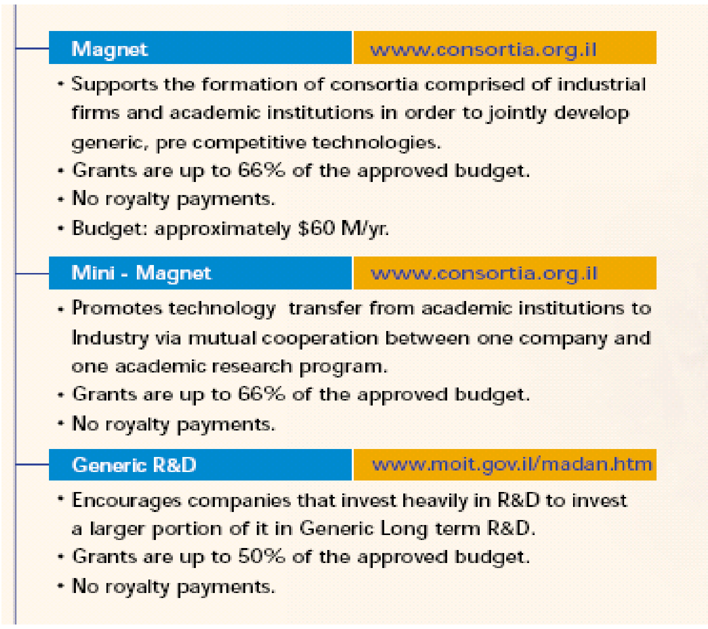
Example I:

The Technological Incubators programme, the Tnufa programme, the Noffar fund, the R&D fund. All of them are state initiatives matched with private interest meant to foster early stage projects. Note patent filing funds allocation.



Example II:

The Magnet, the Mini-Magnet, the generic R&D funds: to support joint industry & academic institutions co-operations.



Magnet www.consortia.org.il

- Supports the formation of consortia comprised of industrial firms and academic institutions in order to jointly develop generic, pre competitive technologies.
- Grants are up to 66% of the approved budget.
- No royalty payments.
- Budget: approximately $60 M/yr.

Mini - Magnet www.consortia.org.il

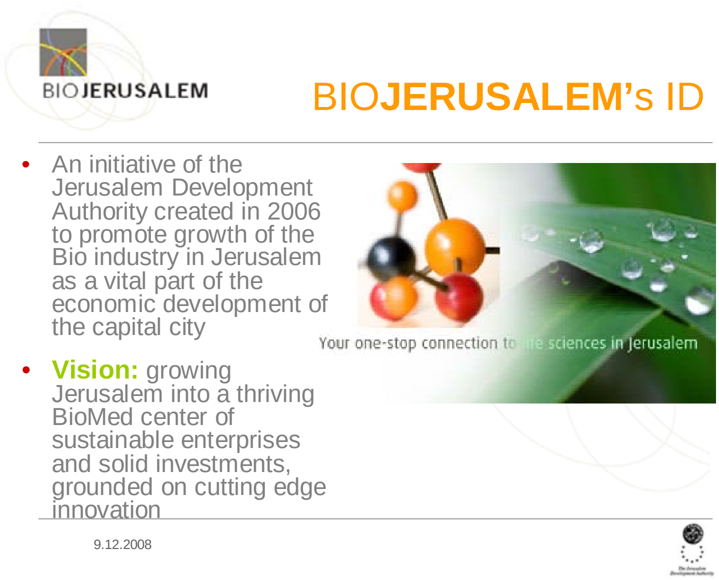
- Promotes technology transfer from academic institutions to Industry via mutual cooperation between one company and one academic research program.
- Grants are up to 66% of the approved budget.
- No royalty payments.

Generic R&D www.moit.gov.il/madan.htm

- Encourages companies that invest heavily in R&D to invest a larger portion of it in Generic Long term R&D.
- Grants are up to 50% of the approved budget.
- No royalty payments.

4. Regional Development

Example: Bio Jerusalem: to foster the creation of a Biotechnology hub in the Jerusalem area.



Understanding that the city is a centre of biomedical research, the Jerusalem Development Authority launched an initiative to cluster its institutional excellencies (Hebrew University, Hadassah Hospital, Van leer Incubator, etc.) and is currently developing the BioMed Park with generous government financial incentives to attract to its facilities biotech, medical devices and pharma companies as well as other investments. One of the program's objectives is to avoid brain drain, keeping skilled professionals from the Jerusalem area in the region.

5. Israeli Universities

Israel's seven research universities are considered veterans in the area of technology transfer. As previously mentioned the first Tech Transfer company, Yeda (meaning *knowledge* in Hebrew), of the Weizmann Institute, was founded in 1959, years before the Bayh-Dole act of 1980 that enabled US universities to capitalize federal funded research results. A few years later, in 1964, The Hebrew University of Jerusalem launched Yissum (meaning *application* in Hebrew) and the other companies followed as their universities were founded and reached research maturity.

Yeda and Yissum are among the highest-earning university technology transfer companies in the world. As a matter of comparison, considering the invested sums, Yissum's achievements are a record.

Example: FY 2007

University	Revenues	Research Budget
HUJ (Yissum)	$51 mil	$107 mil
MIT	$61 mil	$1.2 billion
STANFORD	$50 mil	$1 billion

The scheme behind all Tech Transfer companies in Israel is similar; they are subsidiaries fully owned by the university, with economic autonomy and a clear model of revenues division between the inventors, their laboratories and the university. Inventors are entitled to receive 40% of the royalties inferred personally and 20% to their laboratories. The remaining 40% are divided between the university and the tech transfer company to be used as revolving money for research and maintenance purposes. Universities' rights to the research results stem from Israeli legislation (The Patents Law, 1967, Service Inventions rule) and the Tech Transfer companies are the owners of the university research results by an agreement between the university and the company. Universities' Tech Transfer companies are entitled to identify the universities' innovative and economic value, protect them and promote their commercial exploitation. There are clear regulations that support the activity defined by University regulations and all staff member have to abide to the same.

Yissum's annual activity in intellectual property is of approximately 130 disclosures and about 100 new filings (mainly US Provisional applications) with a portfolio of about 950 live patent families. Our IP budget is the company's highest budget; however, we are worried about the current trends: due to the last economic recession many companies cut their IP expenses and return our licensed patents (and the costs involved in their maintenance).

2007 IP Snapshot

- 121 new inventions;
- 93 new patent applications;
- 64 new patents granted.

While we are proud of our achievements over the years:

- Over $1 Billion annual sales of Hebrew University-based products;
- 5,500 patents;
- 1,600 inventions;
- 480 licenses;
- 65 spin-offs;
- Over $165 mil raised in 2007 from leading VCs and private investors.

Still we owe our revenues mainly to three products:

1. The cherry tomato seeds (mainly protected by breeders' rights) developed by Profs Nachum Keidar and Haim D Rabinowitch and licensed to two Israeli companies; Hazera and Zeraim Gedera, recently sold to Vilmorin and Syngenta;
2. Doxil – Doxorubicin HCI liposome injection, by Profs Y Barenholz and A Gabizon, licensed to Alza and currently Alza's lead product for Oncology; and
3. Exelon – for Treatment of Alzheimer's Disease and Dementia, by Prof Marta Weinstock-Rosin, licensed to Novartis.

7. Problems? Conflicts?

With the decrease of research state funds and the increase of the commercial flow of money to the university, we may face some problems. The most immediate problem could be a possible decrease in our standards of excellence. Another is an on-going ethical preoccupation; there is a constant debate on the possible conflicts of interests generated by a certain dependency on commercial/industrial moneys to the academic system. While we have so far coped with the matter with dignity, we cannot warrant full immunity to this threat in the future.

Conclusion

Is it worth the effort? Is it worth the investment?

Obtaining a patent for a novel technology is a significant investment for universities. Patent protection for a single technology can easily cost $20,000 to $30,000 for U.S. rights only and about $100,000 to have rights in a few additional countries.

But we do make these investments:

a. Because it is necessary for the technology transfer process – companies will not invest in the development of an early stage, high-risk technology unless they may have the possibility of being granted a period of exclusivity for marketing their product under the protection of a patent;
b. Because it gives the universities the opportunity of seeing research results used to the enhancement and benefit of society;
c. Because it keeps talented minds in their institutions;
d. Because some patents may turn out to be worth million-fold their investment;
e. Because it brings funds for research; and
f. Because it allows them to promote social awareness and responsibility.

So far, our experience has been positive.

CHAPTER IV: A CASE STUDY OF BIOTECHNOLOGY: HOW TO CREATE A EUROPEAN BIOTECHNOLOGY CLUSTER FOR ECONOMIC DEVELOPMENT

By Mr. Iain C Shirlaw

Executive Summary

Intellectual property (IP) once created does not necessarily need financing. The idea may immediately attract a buyer who can exploit it, like the better mousetrap.

More often however, the IP requires more time and effort to be spent on it before it can realise its full value. If the national economy wants to see a return from the money it has invested in its university system then it must also set up a framework of support the IP to move further downstream into the marketplace where it can attract a higher value.

In 1975, the UK government set up the Scottish Development Agency as a response the threat of nationalism when prospective oil revenues appeared on the horizon. One of the main successes has been the establishment of a Biotech cluster in Scotland. In 2008, the Life Science sector in Scotland consists of over 620 organisations and over 31,000 employees across the main life sciences segments. This adds in excess of £3 billion to the Scottish economy annually.

This paper gives some insights into how an economic sub-strategy based on a strong intellectual asset base can convert into national economic benefit. It is not a quick fix and involves the establishment of a complex infrastructure that can both lead to new ideas, and can also nurture and support them into the marketplace.

In the oil industry, exploration and discovery is known as being upstream. Downstream activities are refining and marketing to the consumer. Nations with oil and no downstream activity tend not to derive the most economic benefit. Similarly with Biotech the trick is to move downstream to capture more value.

Universities have developed their technology transfer and licensing, the development agency has supported this by developing new early stage investment schemes and by promoting the sector to prospective investors both corporate and financial. In 2007, over £25m was invested in new Life Science companies with strong IP confirming the establishment of a viable industry sector.

The Source – Universities

Unlike oil, IP is purely man-made and in Scotland, its origins mainly arise in Universities. Although lagging behind Italy, France and even England, Scotland's first University was established in 1413 in St Andrews. In 1495, the first medical school in the English-speaking world was set up in Aberdeen. For the next few centuries the universities were the main centres of learning, and as their reputation grew they became more famous internationally. The Royal courts of Denmark and Russia boasted Scots Physicians in the 17th Century; in the 18th century the learning started to become discoveries that changed the world, a cure for scurvy, vaccination for small pox, quinine to treat malaria. This contribution to medical knowledge continued with pioneering of anaesthesia, treatment for tuberculosis, identification of the cause of brucellosis, the hypodermic syringe, a vaccine for typhoid.

In the 20th century, this continued with the discovery of insulin. However the economics had changed. IP had become recognised and the patent system set up. Up to then it was accepted that discoveries would be published for the public good. Alexander Fleming's discovery of penicillin, Sir James Black's beta blocker drugs led to very large profits for the company who exploited the drugs in the world-wide market place. Scotland continued producing techniques such as Professor Ian Donald's use of sonar for medical diagnosis to diagnose an ovarian cyst in a woman who had been diagnosed as having inoperable cancer of the stomach. Ultrasound is now used to monitor the development of every baby in the developed world.

Another technique was Magnetic Resonance Imaging (MRI) for whole-body human imaging, which was first demonstrated by John Mallard at Aberdeen University.

The first product to see significant financial returns to a Scottish University was Atracurium - the muscle relaxant is used by anaesthetists in more than half of all operations worldwide. It has brought in more than £28.5 million in royalties to the University of Strathclyde in Glasgow after being licensed to GlaxoSmithKline although critically in terms of the value created Professor John Stenlake also designed and synthesised the drug in the University.

Know How – Skills and experience

With the knowledge that Scottish Universities can produce world changing ideas, the question is how to develop it for economic benefit. In 1980, the Scottish Development Agency established a Heath Care and Biotechnology Divisions. In 1985, there were nine Biotech companies. In 1985, more than 95% of employment in the sector was in universities.

In 2008, Life sciences research in Scotland attracted £280 million – 15% of the UK total – annually. Scotland has only 8% of the UK population. There are 17,000 researchers who have strong links to key academic and commercial biotechnology organisations across the globe. This global connection has played its part in letting people see how ideas move from the laboratory to the supermarket shelf. Scottish Universities filed over 500 patent applications (15% of the UK total).

The continued funding from public purse is also due to the fact that the Private sector also recognises its value, and 70% of Academic Biotech institutions actively seek out industrial collaboration, compared to the UK average of only 50%.

How did a public sector body manage to get a small company on the edge of Europe to being a recognised centre of biotechnology developments? The answer is that the skills to grow a biotechnology cluster require commercial skills as well as scientific skills.

In 1979, two key unrelated events took place. Sir Kenneth Murray of Edinburgh University became one of the founder advisors of Biogen, Switzerland, Europe's first Venture Capital Biotechnology Company. Biogen Idec now turns over more than $3,000,000,000 and the same year the Scottish Development Agency made an investment in Inveresk Research International, acquiring 90% of the shares.

In 2004, Inveresk was sold to Charles River for £875m, although SDA had sold its shares long before then.

In the next 30 years, more and more graduates found they did not have to leave Scotland for a job. More and more scientists started to learn about the commercial world in a global industry with huge presence on their doorstep. More and more saw their friends and colleagues enjoying the lifestyle that the commercialisation of technology can bring. Placing additional human skills alongside Intellectual Property changed the pattern of investment.

The SDA developed a strategy and facilitated its execution by operating catalytically with all the participants and prospective beneficiaries in Scotland.

Creating Value – Investment

Another Scot, Adam Smith, in the "Wealth of Nations", coined the phrase "the invisible hand" to explain how the free market develops community well. Nowadays, most people also see a role for government. As a region Scotland had to work harder to attract investment from internationally mobile corporate investors. This was the traditional mode which had offered grants for capital investment and had successfully attracted Glaxo, Roche, ICI, Organon, Johnson & Johnson, and Syntex. It was the latter which provided a clue as the Syntex investment was not for production facilities but for R&D.

When I joined the SDA in 1983, we had to develop a new strategy to grow the sector in Scotland. It had to be based on using the IP base to attract investment as other places such as Ireland could offer better terms for subsidising production operations. The three strengths to build on were:

– Universities with strong reputations in Biotech;
– Emerging Venture capital to create new businesses; and
– Attract Pharma companies looking to find "upstream" opportunities.

This had to be a long term strategy, and one of the issues that we had not appreciated was the role that Inveresk Research would play, both directly and indirectly. We were also helped by the work of Professor Michael Porter and his work on "the Competitive Advantage of Nations" which in 1989, provide the academic rationale.

There were several issues to be overcome. In the mid 1980's, most Universities' preferred the model of publishing for the common good rather than develop IP for exploitation. Where they had technology transfer offices, and both Strathclyde were very good, they tended to be looking for large companies to buy their IP at an early stage, with low value add for the local economy.

There were few Venture capital companies in Scotland, although Advent International was founded in Scotland by David Cooksey in 1981, it rapidly moved its base to London. And the pharma companies were quite happy with their close relationships with academics on consultancy contracts through whom they could acquire knowledge about developments in the technologies at the research stage. Which is quite understandable as research is relatively cheap. It is the development, testing production and marketing that costs a lot. Typically, a new product costs \$20m in R&D then \$200m in clinical approvals with production, marketing costs times 10 again.

There were almost no IP-based biotech companies in Scotland in 1979. The first

Biotech company in Scotland was Cruachem in 1980, which was probably based more on know how than patenting. It was set up by a bunch of chemists from Glasgow University making the precursors for DNA synthesis. This was comparable to the first people making money out of the gold rush were the people who sold shovels to prospectors. However, a very small spinout from Strathclyde University, called Monotech laboratories, was one of the world’s first Monoclonal Antibody companies in 1981. It had been set up through corporate venturing by a textile company Coats, Paton but when it needed more funding it was absorbed into Inveresk Research International.

The most difficult thing about strategy is making it work. At that stage, it follows several years of very hard work. I remember driving up to 25,000 miles in a year to develop contact with all the universities and anyone there who wanted to be part of this new exciting biotechnology. And it was exciting, there were very few rules and there was a great buzz in science with companies like Genentech, Cetus and Biogen doing great science and making up new rules for financing IP and technology.

As well as internal promotion, there was a lot of international marketing activity to increase awareness of the potential in Scotland. And back home there was also a lot of work to educate young technologist on how to develop their own markets, and create their business plans, and then to find and to sell their proposal to investors.

There was still a role for physical infrastructure and for investment support. These companies needed much more high specification buildings. They needed clean rooms and expensive equipment. They also needed locations not too far from the Universities out of which these scientists were creating the new businesses. One of the first was the West of Scotland Science Park set up in 1983, and in which Cruachem located. Over the years the model for Science Parks evolved and currently the most successful is Hillington Innovation Centre, which offers a lot more than just an office. It has become a hub into which new technology businesses can come to grow. They are actively support by staff and by being close to and learning from their peers that tend to evolve clusters around current technologies.

One of the earliest university spin-outs supported by the Scottish Development Agency was created from academics at Edinburgh and Heriot-Watt Universities in 1982. It was called Bioscot, and also involved collaboration with the Scottish Blood transfusion service. It spun off Cogent Diagnostics and was later acquired by Serologicals, which was the bought by Millipore. And Keith Thompson, one of the first Bioscot employees, has returned to Scotland as an angel investor and is Director of the Scottish National Blood Transfusion Service as a day job! Carrying on the process of commercialisation from the public sector, Alba Bioscience was a company spinoff generated from SNBTS in 2007.

Results – Strategic indicators

Predictions are notoriously difficult, especially when they refer to the future. The first five-year review showed that targets had been met in term of numbers of jobs created, but they had come from home-grown rather than inward investments! It took until the 1990’s, for most of the efforts to bear fruit. And today there are now more jobs back in the international corporations.

Clearly there are more challenges to face but a lot has been achieved to support the economic value retention from a fruitful source of IP.

A very significant result was the recognition of Scotland as a successful biotechnology cluster. In large part it is due not just to the history but also to the success in which new companies have been set up and financed.

Examples must of course start with Pharmaceutical Proteins Limited, whose collaboration supported the development of Dolly the Sheep. At its peak PPL had a market capitalisation of $500m. Other IP based companies from the 1980's, were Scotgen who emerged from Inveresk and Monotech to exploit Medical Research Council technology from Cambridge and become pioneers in humanised antibodies; Biocure who were one of the sector's first angel investment with cell growth modulating compounds; and Axis-Shield who went through several financial restructurings to become one of Europe's leading diagnostic businesses.

The importance of getting these companies to market was the additional effect they had on changing pharmaceutical companies' perception of Scotland to be seen not just as a source of subsidized investment but as a source of skilled labour, and new technologies which they would either have to compete with or acquire.

The surprise, which is understandable in hind-sight, has been the success of the service companies, organisations who supply services to and who undertake evaluation and development work for Pharmaceutical companies. Inveresk who are now owned by Charles River are joined in the sector by 40 others; Aptuit who were a spin out from Quintiles and which still has a major presence in Scotland; Bioreliance, Invitrogen, Scottish Biomedical, Nexus Oncology and others.

This had brought into Scotland many of the key skills which are required to add value to the biotech IP that is being generated not only in universities.

Each year, around 20 new University spinout companies are formed in the sector. In 2005, 20% of Europe's life science initial public offerings (IPOs) were Scottish. Cyclacel was founded in Scotland in 1996, and is the first – and perhaps only – European Biotech spinout to raise more than $100million.

Other recent successful Scottish IPOs include: ProStrakan, IDMoS and Optos. Perhaps one of the most successful academic spinouts based more on know how than on patents was Professor David Onions and his colleagues when they set up Q1 Biotech. This was founded on Professor Onions' skills and knowledge in the field of retroviruses and testing for their presence. They sold Q1 Biotech to Bioreliance in 2003 for £40m, and are now working on creating another couple of businesses.

On the investment front Scotland has two of Europe's largest private equity investors in Scottish Equity Partners (SEP) and Alliance Trust. SEP was a very successful spinout from the original Investment Fund created by the Scottish Development Agency. Alliance Trust based in Dundee and was originally formed to provide loans to immigrant farmers on the West Coast of America in 1888. A significant player in the sector is the Scottish Widows Investment partnership whose £40m Healthcare portfolio is run by Bill Blair, an industry veteran.

The most significant factor in funding new technology in Scotland is now the Angel Investment syndicates. The first was Archangels, which was set up in 1992. It now has around 80 members and invests more than £8m a year in new businesses. There are now about 30 informal syndicates involving more than 300 private individuals prepared to invest their own money in new business.

As activity in the sector has progress the Economic Development role has changed. There is very little done in the area of “hard” infrastructure of purely property. The focus is moving downstream from encouraging spin-outs to increasing their ability to grow. More specialist advisory and financing vehicles are being developed. The Scottish Government has created SMART (Special Merit Awards for Research and Technology) to encourage inventive scientists to develop their ideas beyond research grants.

Scottish Enterprise, the successor body to the SDA, has pioneered initiatives such as a Proof of Concept fund and Enterprise Fellowships, in association with the Royal Society of Edinburgh, to show that the application of science is as important as the invention.
Next in sequence is the Seed Fund to support spin-outs and the Co-investment Fund to double the fire power of angel investors, and a new Venture Fund to bridge the remaining gap to attract in larger international venture funds.

Alongside these there are additional European funds that provide regional development grants to encourage investment into areas designated as requiring additional economic regeneration.

Scottish Government support	**Fund Size**	**Investment Range**	**% Life Sciences**
SMART for SMEs	£7m p.a. (£32m over 5 years)	Up to £600k (35% of total	64%
SE Investing			
Scottish Seed Fund	£2m	~ £100k	
Scottish Co-investment Fund – *April 2003*	£11m	£100k - £1m	32% (£13m)
Scottish Venture Fund – *Jan 2007*	£10m	£500k - £2m	28% (£5m)

Scottish Enterprise invests approximately £25m p.a. - around 30% of that is in Life Sciences.
All funds invested are matched by private sector funding on at least 1:1

The bigger financial numbers come in when international players join the landscape. In 2006, Wyeth committed $45m to Translational Medicine Research; in 2009, Schering-Plough announced it was to invest around $30 million in its early drug discovery work in Scotland. Also this year, Invitrogen will spend $23.3 million to create a new global corporate research centre near Glasgow, which will also become Invitrogen’s new European headquarters.

And the final demonstration of success is the much larger number of consultants, lawyers in IP, corporate finance and Patent attorneys who now apply their trade in Scotland.

Murgitroyds, who are among the largest and most progressive firms of European patent and trade mark attorneys now have a staff of around 220, including around 90 professional staff operating from 12 European offices and a U.S. Development & Client Management

Office. Lawyers tend to be good at following the money.

Lessons and Conclusions

Looking back over 30 years shows that the strategy of focusing on the biotech sector has shown a relative degree of success. It has demonstrated that the knowledge base has been able to support a considerable degree of economic development.

The Haptogen story (see box), brings to Scotland a major international pharmaceutical company in Wyeth/ Pfizer keen to enjoy the benefits of a talent pool and access to areas of breakthrough biological sciences. Haptogen had its roots in Monotech in 1981, and the link extended into Inveresk from where Bill Harris attracted investment from Cogent to set up Cogent diagnostics and then to set up Scotgen in Aberdeen, which established the skills in engineering antibodies that resulted in Andy Porter setting up Haptogen in 2002.

The situation today:

- The Sector shows growth of 8% from new and existing business;
- There is increased patent activity, mainly from universities and increasingly from companies active in research;
- There has been considerable inward corporate investment for technology, and for service industries;
- The emergence of the development of early stage funders from angel syndicates has been ahead of other regions of Europe; and
- This development has been strategically supported by Scottish Enterprise by promoting opportunities and then tactically encouraging, with various infrastructural supports the funnelling of private sector investment into areas which had been perceived as technically risky.

However it seems that the story is not over and there is still more to be done to fully realize the potential of knowledge and intellectual capability in a way that optimizes the economic development potential. This can be summarized in the oil analogy that we are still too upstream focused. We now understand the systems to get the potential wealth out the ground but have a way to go to secure the full value development by from upstream to downstream with a stronger base of indigenous companies able to grow to taking a more significant role on the world stage.

At the core of this problem is the need to develop skills more based on technology exploitation than on developing new technology. It is the commercial skills that investors are looking for. The best way to safe guard their investment is to have companies whose management has a successful track record in growing technology businesses.

Finally there need to be more exemplars of business success and further efforts to market the opportunity and convince both corporate and direct investors that Scotland's

Wyeth Pharmaceuticals Acquires Haptogen Ltd. to Boost Biotechnology Drug Discovery

October 5, 2007

Wyeth Pharmaceuticals has acquired Haptogen Ltd., a Scottish company based in Aberdeen that is focused on the discovery of biopharmaceutical therapies.

"Haptogen brings to Wyeth a suite of next-generation biotechnology discovery technologies that complement Wyeth's ongoing biotherapeutic discovery efforts," we consider the opportunity to conduct biopharmaceutical drug discovery in Scotland particularly important because of the rich pool of scientific and technological

IP rich biotech cluster is able to provide any financing with a return on investment.

It is axiomatic that there is always investment for good ideas with good management. Scotland has great and productive BioScientists. It is growing the commercialization skills that attract international investment. Even in these uncertain economic times, future investors will seek the teams of people that can give the return on their money and see biotechnology being a very significant contributor to both local economic wellbeing, and worldwide health improvements.

CHAPTER V: FILM FINANCE IN NIGERIA

By Mr. Dayo Ogunyemi

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1. Synopsis

This paper focuses on the evolving practices and challenges relating to financing films in Nigeria, home to Nollywood, Africa's largest film industry. The paper briefly compares film financing in the United States and Nigeria as well as the industry structures and practices upon which the financing depends in each country. It identifies challenges posed by the way Nollywood is structured and identifies key elements that need to be put in place for film financing to expand successfully in Nigeria, elements that are also applicable to the nascent film industries elsewhere in Africa.

2. Film? In Africa? Why film finance in Africa is important

Movies arguably currently constitute Africa's most valuable intellectual property (IP) products. Aside from the potential that film has for socio-cultural transformation in Africa, the movie industry is the most active and valuable part of the internal knowledge economy in Africa today, vastly outpacing the growth of the publishing, music, and software industries. It is therefore critical to Africa's economic growth that its formal financial sector is able to engage productively with the film industry.

The very emergence of a market-driven film industry in Africa is something of a rags-to-riches story. From the ashes of a television industry laid to waste in the 1980's, by a crumbling domestic economy, Nigerian directors and producers developed Nollywood by adopting disruptive new technologies – affordable digital video cameras and computer-based editing suites – to meet the local demand for filmed entertainment. That cycle of innovation has paid off – while the global movie industry is looking to digital movie-making as its future, Nollywood's very DNA is based on it. Nollywood is now the 3rd largest film industry in the world by output, after Hollywood and Bollywood, with anywhere from 1200 to 2000 movies produced and released commercially every year.

The basic Nollywood model is small-budget (typically under $150,000), quick turnaround (with typical shooting schedules of 20 to 30 days), high-volume movie making. In recent years, as Nollywood fare gained international fans in African diasporas and beyond, the industry began to pay more attention to improving technical and aesthetic quality of its product. It now boasts a huge and growing global fan-base, with a well-established star system for talent. Importantly, it has served as a model and inspiration for small-budget digital movie making elsewhere on the African continent, spurring the birth of Riverwood (Kenya), Gollywood (Ghana), etc.

3. Hollywood vs Nollywood: Industry structure

Budgets aside, the main differences between film financing in the United States and Nigeria are inextricably tied to the movie industry structure in each country and the sorts of revenue model associated with them. In both countries, unlike in many European countries, the successful development of a movie project is largely dependent on its commercial prospects, with government funding and co-production treaties playing an insignificant role in financing.

The Movie Industry in the United States

Movie production and distribution in the United States is largely based on a system dominated by the “major” studios – movie producers and distributors including Fox, Universal, Sony, Time Warner, Paramount, Walt Disney, which are all part of large publicly traded media conglomerates. Although the United States has historically had an active system of independent producers, in the past decade and a half major studios looking to acquire relatively low cost, edgy content have snapped up many of these.

Hollywood’s revenue picture is well defined – once a movie is completed and released commercially, it is exploited through a series of exhibition, home video, pay TV, free-to-air broadcast windows with associated revenue flows in both domestic and international markets.

Home video – encompassing video rentals and sales to consumers – make up fully half of industry revenues, while theatrical and ancillary (broadcast and pay television) each account for about 17%.

The Movie Industry in Nigeria

The Nigerian movie industry, in contrast, is very different. Nollywood has large numbers of independent filmmakers, as might be expected from a country with a population of 150 million, roughly half that of the United States. Although there are major distributors (known as marketers) that have a semi-formal network built around the industry centers of Idumota in Lagos and Upper Iweka Road in Onitsha, Nigeria has no major studios built around production.

Nollywood’s loose distribution framework is centered almost entirely on the home video format and the domestic market. While domestic and foreign home video sales and rentals contribute roughly half of all Hollywood revenues, home video (consisting almost entirely of sales, not rentals, to consumers located within Nigeria) alone accounts for over

90% of Nollywood revenues. All other revenue windows are either non-existent, severely eroded by piracy or at fledgling stages of development.

These differences in industry structure and practices have some profound consequences for the financing of movies in both countries.

4. Hollywood vs Nollywood: Film financing

Film Financing in the US

In the US, movies are financed using a variety of the following means, depending on whether they are initiated as independent or major studio projects. The majors, who are all parts of large, publicly traded media conglomerates, have unparalleled access to capital, and typically finance self-initiated projects in-house. However, many movies begin their lives outside the major studio system, even if their eventual commercial release and success depends on their being acquired or distributed by the majors. In exchange for certain rights, major studios will sometimes provide financing for a promising project requiring gap financing – funding for a portion of the overall budget. The major studios also do “negative pick-ups[162],” – acquiring key rights to a movie after it has been completed, thus avoiding the substantial risk of sub-par or non-completion.

For non-studio movies, producers must independently raise the money required to acquire the necessary rights, attach talent and shoot, edit and complete the movie. Producers with a strong track record can pre-sell the wide variety of rights in their project corresponding to the windows outlined above (domestic and foreign theatrical exhibition, broadcast, home video) etc. Such projects can also utilize equity financing from private investors, as well as production loans from banks. It is important to understand that production financing by banks mainly consists of loans based on some discounting of projected future revenue flows based on third-party contractual obligations and historical performance.

Apart from banks, other financial institutions play risk-reducing roles in film financing. Insurance companies, for instance, will also provide completion guarantees – essentially financial guarantees that a film project will be completed even if it runs into problems like budget overruns, etc. They also provide errors & omission insurance that, among other things, can provide a monetary backstop to purchasers and licensees (e.g., broadcasters) of a finished movie against liabilities relating to improperly cleared intellectual property and personal rights. These financial products play an important role in signaling to potential business partners that a marketable and valuable asset will emerge from the complex and often confusing process of creating a movie.

Financing Nollywood Style

Film financing in Nigeria is vastly different from the system which operates in the United States. In the early days of Nollywood, a movie would be entirely self-financed by the producer/director, who would then look to film marketers to distribute the finished movie. The opaque, semi-formal nature of distribution in Nigeria gave rise to many disputes around

[162] For the vast majority of US releases, the completed movie is known as a negative – the 35mm master from which prints are created for exhibition, usually the first in the series of exploitation windows for a commercial project.

sales figures and accounting and, similarly to the Hollywood negative pick-up, it became common for marketers to buy-out film rights. Eventually, like the US majors, some marketers got more involved in producing – making key decisions on talent and story – with the director functioning as a hired gun. However, the informality of the industry meant that contracts are rarely signed to delineate ownership of the underlying intellectual property rights.

In recent years, with awareness of Nollywood’s growing global impact growing in governmental and corporate circles, some efforts have been made to improve Nollywood’s access to formal finance. Some banks have experimented with providing non-recourse production loans (historically, some film makers had obtained bank financing, but these were largely secured by the borrower’s personal assets and were really no different from a personal loan, as the banks did not look to the IP asset as collateral, even in finished form). Other banks provided financing for production slates, but usually for films or television programs that included promotion for bank, so these projects really constituted a mix of non-recourse financing and sponsorship/advertising. However, these efforts have not appreciably expanded the options available to filmmakers in Nollywood.

5. Elements for successful film finance

Successfully raising financing from third parties for the making of a movie is very much dependent on the processes for establishing ownership of IP assets and recording security interests in these assets. Investors or lenders must be satisfied that both the capital they provide will be properly used to transform an idea or concept into a marketable intangible asset, and that they will have a means of asserting their economic interest in the asset. This usually means that financiers require:

A clear chain of title

A completed movie incorporates a wide variety of underlying IP rights and other intangible assets. Depending on how the project was developed, these could include an adaptation of a novel or an original screenplay, several script revisions, a soundtrack incorporating musical compositions and sound recordings licensed from third parties, etc. Also, a wide variety of creative types are involved in a project’s gestation.

It is therefore critical, for third party financing, that the various rights and relationships between relevant parties be properly spelt out and documented. This is done in documents constituting the chain of title.

An efficacious registry for recording ownership and/or security interests in the completed movie. As it is for tangible assets, equity investors and debt providers need to be able to establish their claims to the economic value that a movie represents, even though it is an intangible asset. Linking a registry with security interests to one with IP rights will significantly improve transparency, and make movie projects more bankable.

6. Keys to improving Nollywood’s access to finance

The continued growth and evolution of Nollywood suggests that the industry will attract more formal financing over time. While Nollywood’s freewheeling nature gave it an opportunity to grow under extremely difficult economic circumstances, it is now an encumbrance to further growth and development. The elements of third party finance identified in the previous section provide some guidance to improving access to financing for films in Nigeria.

In addition, the industry itself needs to be restructured – particularly with respect to exhibition and distribution – and formal documentation and accounting introduced. While the financial sector needs to improve its understanding of Nollywood, clean chains of title and efficacious means of recording security interests can only enhance, and not replace, factors like stable and transparent revenue streams that banks can rely upon to justify debt financing. With these issues resolved, the financial sector can engage productively by providing products and services that meet the financing and risk-management needs of the industry. In more detail, the key issues that need to be resolved include:

a. Developing and formalizing multiple revenue streams

Critically, the industry needs to formalize the sources of its revenue streams, as well as establish broader avenues for formal income, particularly in foreign markets. Developing a wider range of predictable income streams, especially with credible counter-parties, will provide greater comfort for formal third party financing.

b. Establishing and registering ownership rights

In Nigeria, the movie industry's informal roots continue to pose a challenge to the expansion of IP financing. Chain of title is seldom clearly established in Nollywood movies from project inception. This is in part because adaptations of existing work are rare (or rarely acknowledged) as is optioning of stories or scripts. Also, most scripts are acquired outright or developed 'in-house', and back-end participation by above-the-line talent is uncommon.

Ostensibly, producers can register a finished movie with the Nigerian Copyright Commission (which is currently led by a much-admired attorney hired from private practice and is now very proactive about copyright enforcement). However, copyright registration is not a common industry practice, and the absence of a culture of signing contracts to cover key predicate actions as well as relationships over the development cycle of the movie mean that copyright registration would merely change the initiating point of disputes over IP ownership.

c. Recording security interests and linking to the transfers of rights

The absence of strong secured transactions laws in Nigeria poses an additional challenge to film financing. Currently, Nigeria does not have a well-established process or registry for recording security interests like UCC filings in the United States. Creating such a process and registry and linking this to an IP rights database would greatly facilitate third-party film financing.

d. Improving industry awareness and understanding on the part of financial institutions

Most banks and insurance companies in Nigeria are simply insufficiently informed about the movie industry to evaluate opportunities and risks with financing that sector. While a few banks have established dedicated entertainment desks and practices, the financial sector there still has an insufficient understanding of the economics of film in general and industry structure in Nigeria in particular. It would help significantly if financial institutions gained a better understanding of the market potential and financing needs of the industry.

e. Introducing risk-reducing financial instruments

In the United States, the existence of financial products like completion guarantees and errors and omission insurance play important roles in ensuring that movies are made and subsequently that they can be freely exploited through third parties to generate income. The absence of such products from the Nigerian market is in some ways both cause and consequence of gaps in the industry structure that make it more difficult to finance films. Successfully introducing them would significantly facilitate the growth of the industry but would require a reform of Nollywood industry structures, particularly those that relate to the distribution and exploitation of movies.

CHAPTER VI: ENDUSER FINANCING OF SOFTWARE

By Ms. Leianne S. Crittenden

We have been financing our customers' acquisition of our software and services for almost 20 years. We operate on every continent from major developed economies, to newly emerging countries. In every country even now "software financing" is considered "unusual" – "How do you do that?" people ask.

Unlike the financing of another copyrighted product – movies – there is not an established way to provide software financing. Software financing contracts will provide a payment alternative to end-user customers, and can be structured as instalment payment agreements or as lease agreements. There are no laws that directly authorize the financing or leasing of software in order to provide, for example, the statutory insulation from product and performance claims. For example, in the United States, these protections are given to lessors of goods under a "finance lease" under Uniform Commercial Code (Article 2A). Instead, these transactions are contractual arrangements, which are structured to provide the parties with the obligations, protections and remedies that they might otherwise have if the transaction were a goods-based transaction.

To provide software financing in many disparate markets and legal systems, we try to construct the contracts to protect each party's legitimate (but competing) interests, as well as fulfil the parties' expectations under competing areas of law (such as commercial law, intellectual property ('IP') law and insolvency law).

Types of Law

These materials discuss end-user software financing, and while in many instances they refer to United States legal principles, the discussion highlights issues that are common around the world, due to the inconsistencies between commercial, insolvency and IP laws. These laws all have different, but legitimate, objectives.

- *Commercial law* seeks to facilitate the use of capital by providing clear statements of rights, priorities and remedies;
- *Insolvency law* seeks to reorganize or liquidate a debtor in the most efficient manner to the benefit of all creditors, in accordance with their rights under commercial laws;
- *IP law* seeks to protect owners of ideas, images and processes, and allows them the right to obtain value from the distribution of those assets.

Interests of Parties

In addition, in a software financing transaction, the contract needs to assure that the legitimate expectations of the parties are respected:

Licensee:

- needs to have right to use software, as agreed in the license; and
- wants to pursue claims against the licensor directly (not through a funder).

Licensor:

- wants license terms to be observed and enforced directly against licensee;
- wants to be paid;
- wants licensee to pay for use – whether it pays licensor or its assignee;
- wants to control distribution of its intellectual property; and
- funder is not entitled to distribute the license without licensor consent.

Funder:

- wants to assure that is paid;
- wants to make sure it is not subject to IP claims properly brought against licensor;
- wants an effective remedy; and
- wants a familiar financial instrument (lease or instalment payment terms) with familiar terms and conditions, to assure predictable outcomes.

Types of Software Financing Contracts

Funders (the term includes banks and leasing companies that provide leases or instalment purchase contracts for the acquisition of software), want to have similar protections to those they would have for tangible assets, to the extent possible. To achieve this, software financing contracts are typically structured using familiar terms and conditions. An instalment payment agreement ("IPA") can be used to pay for the acquisition of specific assets, or a lease contract may be used, so long as the lessor has rights in an asset that it is permitted to lease. Where the lessor is the licensor, the licensor has rights that can be leased, and where the lessor is not the licensor, the lessor needs to acquire something that it can lease (either from the licensor, or from the licensee).

These structures are generally familiar around the world, are acceptable in the financial markets, and are relatively simple documents, based on established forms of documents. However, those familiar documents do need to be tailored for IP rights.

IPA Characteristics

The IPA is a separate agreement from the license, with an unconditional promise to pay for the IP assets acquired from the licensor. It may be entered with the licensor, or be structured as an advance payable to the licensor to pay fees due for the acquired assets. Repayment of those fees is made pursuant to the IPA.

The IPA will also contain representations, covenants and defaults that are separate from and in addition to the terms contained in the license. Since the asset that is acquired is a contract right (and not a tangible asset that can be repossessed or seized), in some cases, the IPA will also include a remedy that if there is a default, the licenses that were paid for can be terminated.

Software financing contracts are not a "collateral" play – this is because most licenses will not allow a transfer of the license without the licensor's consent. That means, since a funder's rights derive from its agreement with the licensee, that if a licensee could not transfer the license, then a funder would not have the right to transfer the licensed rights upon a licensee's default under the IPA without licensor consent.

The right to use the licensed software is subject to the terms of the license agreement, so the funder's "collateral" is also subject to the licensor's rights. For instance, if the debtor defaults under its license, the licensor always has the right to terminate that license, thus destroying the funder's "collateral" (since the licensee no longer has the right to use the software).

This risk of license termination is a risk inherent in a software financing transaction. As a result, in most software financing contracts, a license termination allows a funder to declare a default and accelerate payments.

Because there are no laws providing for a separate funder's remedy, as part of the assignment and funding process, where a licensor enters the IPA, it may also agree that the licensor will observe a termination exercised by the funder. By contract, the payment obligations are unconditional and are not subject to any defence, and the licensee agrees that any product or performance claims will be made only against the licensee.

Preserving Licensee Rights

The IPA changes the terms and conditions relating to extended payment terms and remedies, but does not impact the terms of the license grant or rights to use, or warranty or refund provisions in the license. The idea is to put the licensee in the same position as if it had paid cash – it has all the licenses, and the rights under the license, and is obligated to pay the fees due to the licensor. The IPA does not change the obligation to pay those fees; it just changes when they may be paid.

Preserving Funder Rights

The funder investing in a financial instrument expects a full repayment, and wants remedies that will encourage payment rather than a default. IPAs will generally separate the license rights and obligations from the payment terms. The IPA containing those payment terms can be separately assigned to a funder, which allows the license relationship to continue. By entering a separate contract, the funder also is assured that it has not assumed any obligations under that licensing relationship.

Preserving Licensor Rights

The licensor expects to preserve the license relationship it has negotiated with its licensee. Since the right to use the licensed software is subject to the terms of the license agreement, the funder's "collateral" is also subject to the licensor's rights, as well as any limitations in the license.

Software Lease Characteristics

For a "software lease," the same concerns about preserving the parties' rights and expectations apply, as set forth above, with the following differences.

The "asset" that is leased is the right to use the license. The lessor can obtain that right either from the licensor directly, or from the licensee with licensor's consent. The characteristics of the leased asset are set forth in the license agreement. So, if it is a perpetual license, this is as close as a license can get to a transfer of title – a concept applicable to tangible asset (but not to a license). To provide a lease, the duration of the license must be shorter than the useful life of that asset, and lease payments with a purchase option (if applicable) to acquire the license rights must be added – so the license needs to be amended to form a lease transaction. In addition, in order to provide a lease, as noted above, the lessor must acquire an asset to convey to the lessee through the lease contract (otherwise the transaction is a financing arrangement).

Under the lease contract, comparable to a lease of goods (where the vendor of the asset retains obligations to the Lessee for the product), the licensor retains all rights, remedies and obligations except the lease of the right to use the software. This keeps the lessor from assuming licensor obligations such as warranty and refunds for product performance, or indemnification for infringement claims (those obligations remain with the licensor).

The license is amended to provide the licensee with a limited right to use during the lease term, until all the lease payments are made. At the end of the lease term, the licensee may (depending on applicable local law) acquire the right to use, renew the lease or return the leased software. This may or may not qualify as a "lease" under local laws concerning finance leases. Those laws often provide for unconditional payment obligations and other terms for leases that meet the statutorily defined conditions. Those laws may limit "leases" to transactions in goods or tangible assets, or may require specific financial structures. If a software lease does not meet those requirements, it may not have the statutory protections provided for those finance leases – but that does not mean that it is not a lease – it just is not a finance lease subject to those laws.

Acquisition Financing Right Needed

To assure that a funder of a software financing contract can have first claim on the rights and remedies it has in the IP, either through a lease or IPA, an acquisition financing right is needed for the financed IP, so that other creditors of the licensee do not have higher priority in claims for money and assets related to the software financing contract. Even though a license does not transfer title, a perpetual license is close to a transfer of title in the licensed rights (so long as the license terms are met).

Where a software financing contract is involved, a remedy allowing termination of a license may not be adequate to assure repayment of sums due to a funder, especially if those other sums are claimed by other creditors of the licensee, and the funder has no priority in its claims.

Insolvency issues and Licensor Control of Distribution of its IP

In general, insolvency courts have very broad powers to dispose of a debtor's assets to complete a restructuring or liquidation of the debtor. Often, a court could transfer a license, even if it contains an anti-assignment clause, to a new entity. This could happen without notice to a licensor and could happen over the licensor's objection. A licensor expects to have the right to control the use and distribution of its IP, and will want to preserve that right, even in an insolvency proceeding. A funder or insolvency court wants to quickly and efficiently restructure or liquidate the debtor, and obtain the best result for all creditors.

While a licensor may have significant interest in who the license is transferred to, an objection to a proposed transfer by the licensor may slow the insolvency process. For example, a software licenser would not want the license transferred to one of its competitors, and would also not want a transfer made if that transfer would violate the export laws and result in severe penalties on the licensor. In some instances, a transfer from an insolvent licensee may not be an issue where a receiver or debtor wishes to assign the license. For example, if a licensor also has annual renewals of the support services contract for its licensed software, a transfer to an entity that will renew that support contract will not be an unattractive business proposition (unless the transfer takes a potential sale from the licensor).

The point is that a licensor will not generally agree to have a third party (one that the licensor did not contract with) determine who uses the licensor's IP, because the licensor is the one entitled to distribute it.

Conclusion

End-user software financing can be done, but as noted, the transactions need to be properly structured to preserve the parties' rights.

Current law only allows contractual protection, and not a statutory protection to the parties, and the applicable laws do not adequately address the financing of IP. The unique characteristics of these assets are not addressed in either commercial or insolvency law, just as IP law does not contemplate the broader aspects of commercial financing transactions.

As a part of the process of reviewing the commercial and IP laws, issues arising in insolvency must also be addressed, as the structures used and contractual agreements entered to preserve the rights and commercial expectations of the parties could be unpredictably altered if insolvency laws do not preserve those expectations. That is why both an acquisition financing right applicable to IP and the preservation of the licensor's right to control distribution of its IP are important issues to address.

We appreciate the opportunity to participate in this important process of clarifying the laws in this area. We expect that providing clarity in this area of IP financing will attract capital to provide funds for the acquisition of those assets, which will enable a more rapid distribution of technology.

CHAPTER VII: PRESENTATION BY THE DEPUTY MANAGING DIRECTOR NATIONAL EXPORT-IMPORT BANK OF JAMAICA LIMITED

By Ms. Megan Deane

This paper was presented in the context of the WIPO Information Meeting on Intellectual Property Financing – a forum that allows for the full exchange of information in an area which the EXIM Bank of Jamaica recognises as having significant potential for contributing to the economic development of our country.

For those who are not already aware, Jamaica is an island nation of the Greater Antilles, situated in the Caribbean Sea. Jamaica is about 145 kilometres (90 mi) south of Cuba, and 190 kilometres (120 mi) west of the island of Hispaniola, on which Haiti and the Dominican Republic are situated. We are English-speaking, with an estimated population in 2008, being some 2.8 million persons living on the island. The Jamaican economy is heavily dependent on services, which now account for more than 60% of gross domestic product (GDP). The country continues to derive most of its foreign exchange from tourism, remittances, and bauxite/alumina. Remittances account for nearly 20% of GDP and are equivalent to tourism revenues. There is an area however in which it is increasingly felt that Jamaicans have a comparative advantage that can add significantly to the services area and that is in the creative industries including the visual and performing arts – music, film, painting, sport, dance etc.

Most places in the world where you may travel, people know of Bob Marley and his music; many know of Peter Tosh and Jimmy Cliff, more recently Sean Paul and Ziggy Marley, to name a few. The music industry is huge and involves not just the artists but the people behind the scenes such as the producers, lawyers etc. Then, there is “Brand Jamaica.” Who, in watching the last Olympic Games in Beijing, China, would not have come to realize that there was a small country somewhere in the Caribbean that had given birth to the two fastest men alive and the five fastest women. When Jamaican sprinter, Usain Bolt broke the world record and held up his golden PUMA spikes, PUMA stores sold out in Japan. He, himself, is now one of the biggest brands around.

When as a tropical country, Jamaica put forward a bobsled team at the winter Olympics several years ago and bettered many other teams from countries with temperate climates and snow, the bobsled team also became a brand with a recently formed tourist attraction in Jamaica capitalizing on their popularity.

One local pundit, in fact, estimates that, “the hosting and branding of music and sporting events are far more attractive and could yield more revenues than the marketing of sand sea and sun in this environment”[163]… These “views are supported by studies conducted by Drs. Michael Witter and Vanos James of the University of the West Indies (UWI) and the University of Technology (UTECH) in Jamaica, respectively, as well as by studies carried out by John McMillan of Stanford University in the United States. All of these studies indicate

[163]Mr. Howard McIntosh, Interim Chairman – Reggae Industry Association of Jamaica, “Music, Sports and Creative Industries Can Drive FX Flows” (SH) The Sunday Herald March 1-7, 2009, p.18, at *www.sunheraldja.com*.

that the music industry for example, has vast foreign exchange earning, tax generating and employment creating potential[164]."

It is for those reasons that the EXIM Bank would wish to see how we can facilitate the unlocking of the value that is inherent in intellectual property ('IP') rights.

The island has seven (7) Commercial Banks:

- The Bank of Nova Scotia Jamaica Limited;
- First Caribbean Bank International (Jamaica) Limited;
- Citibank, N.A.;
- National Commercial Bank Jamaica Limited;
- First Global Bank Limited;
- RBTT Bank Jamaica Limited; and
- Pan Caribbean Bank Limited.

And three (3) Merchant Banks:

- Capital & Credit Merchant Bank Limited;
- Scotia DBG Merchant Bank Limited; and
- MF&G Trust & Finance Limited.

All of which operate on the island. These entities are regulated by the Central Bank of Jamaica and operate either under the Banking Act or the Financial Institutions Act.

In terms of IP and the acquisition of the rights associated with them[165], Jamaica is a member of various international treaties and uses the standard protocols:

- Copyright;
- Patents, Trademarks, Industrial designs;
- Assignments and Licenses, etc.

Facilitation of these protocols are covered under own local legislation, namely the Copyright Act 1993; Patents Act 1857; Trademarks Act 2001; and Designs Act 1937.

Our own Jamaica Intellectual Property Office (JIPO)[166], which is a member of WIPO, was established on January, 2001, and acquired its status as a statutory corporation on February 1, 2002, out of the recognition by the Government of the need to streamline, modernise, and provide a focal point for the administration of both Industrial Property and Copyright and Related Rights, in order for it to fulfil its bilateral and multilateral obligations in the field of IP.

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[164] "Music, Sports and Creative Industries Can Drive FX Flows" (SH) The Sunday Herald March 1-7, 2009, p.18, at *www.sunheraldja.com*.

[165] Information on the Jamaican Legislative Framework for Intellectual property was taken from the paper, "The Legal Framework for Protecting Creative Assets and Harnessing their Value" by Dianne Daley, Intellectual Property Partner, Foga Daley – Attorneys at Law, presented at the EXIM Bank Seminar – INTELLECTUAL PROPERTY – TAKE TO THE BANK! held July 9, 2008.

[166] Information on JIPO was taken from their website, at *www.jipo.gov.jm*.

JIPO has the critical mandate of administering IP systems in Jamaica, in the areas of trade marks, industrial designs and geographical indications, copyright and related rights, patents, new plant varieties and layout-designs (topographies).

Their primary objectives are listed as follows:

- To contribute to national economic growth and development through the proper protection, administration and enforcement of IP Rights (IPRs);
- To provide Jamaican creators, investors, and commercial enterprises, as well as foreign rights holders with modern and comprehensive procedures and facilities for the protection of their IPRs;
- To facilitate an international level of IP protection for Jamaican rightsholders;
- To heighten public awareness on the importance and economic value of IPRs and the end need for the protection of these rights; and
- To facilitate the improvement of the IP system in light of new technologies and globalisation of trade, through the modernisation of the laws and the accession to relevant international treaties and agreements.

The Government of Jamaica’s international obligations on IP arise under various multilateral agreements and treaties to which Jamaica is party.

Multilateral Treaties

World Intellectual Property Organisation (WIPO)

- The Berne Convention for the Protection of Literary and Artistic Works;
- The Brussels Convention relating to the distribution of programme carrying signals transmitted by satellite;
- The Geneva Convention for the Protection of Phonograms against Unauthorised Duplication of their Phonograms;
- The Nairobi Treaty on the protection of the Olympic Symbol;
- The Nice Agreement concerning the international classification of goods and services for the purpose of Registration of Marks;
- The Paris Convention on the Protection of Industrial Property;
- The Rome Convention for the Protection of Performers, Producers of Phonograms and Broadcasting Organisations;
- The Vienna Agreement establishing an International Classification of the Figurative Elements of Marks;
- The WIPO Copyright Treaty; and
- The WIPO Performance and Phonograms Treaty.

World Trade Organisation (WTO)

- Agreement on Trade Related Aspects of Intellectual Property (TRIPS)

Bilateral Treaties

The Jamaica/USA Bilateral Agreement on the Protection and Enforcement of Intellectual Property Rights

The National Export-Import Bank of Jamaica, (EXIM Bank), commenced operations in 1986, as an independent trade financing institution wholly owned by the Government of Jamaica. We provide short-term financing to the non-traditional export sector to cover pre-shipment costs and post-shipment receivables. We also administer trade credit receivables made available through Foreign Lines of Credit; offer medium term financing through specific loan programmes and encourage trade development by offering Trade Credit Insurance against commercial and political risk. As a trade credit insurer, EXIM Bank Jamaica is also a member of the Berne Union which is an association of some fifty-one (51) public and private trade credit insurers worldwide.

In addition to allowing direct access, the EXIM Bank operates through a network of Approved Financial Intermediaries (AFI's), most of which are the Commercial and Merchant Banks mentioned above. We ourselves however are not regulated by the Bank of Jamaica as we are not a deposit taking institution. Neither are we currently regulated by the Financial Services Commission and use the word "Bank" in our name by special permission from the Ministry with responsibility for Finance. We, however, have always voluntarily complied with the Basel Committee's Principles for Banking, especially given our many Correspondent Banking relationships. We applied for and by way of Order dated June 10, 2008, issued by Jamaica's Minister of National Security, were designated a financial institution for the purposes of the Proceeds of Crime Act (POCA). This designation obliges the Bank to comply with the regulations imposed by POCA and subjects the Bank and its employees to the penalties and fines applicable under POCA in instances of breaches of the Act and its regulations. In that circumstance, we anticipate that we will shortly be supervised by a supervising authority and given its mandate, more likely than not, it will be the Financial Services Commission.

The last several years of our operation have been characterised by innovation, achievements and changes. The Bank embarked on a mission to rebrand and reposition itself in the Jamaican financial services sector through an aggressive and sustained marketing and advertising programme, aimed at promoting EXIM as the "Preferred Bank for the Productive Sector", geared to assist not only exporters, but a gamut of producers and entrepreneurs. The programme also supported our core initiative of loan portfolio growth, central to the Bank's sustained viability and critical to the expansion of the country's productive base.

Our strategic direction is also very clear. We are at the end of the first year of our second Three Year Strategic Plan. What we call our "2010 Vision". Articulation of our vision allows us to focus on a number of key initiatives which include:

- *Growing the Loan Portfolio* with emphasis on attracting new business from emerging industries such as may emanate from the Minerals Industry;
- *Sourcing Low Cost Funds* for on lending at competitive rates of interest;
- *Increasing Tolerance for Credit Risk* through the relaxation of some of the more stringent collateral requirements for viable projects;
- *An Aggressive Marketing and Advertising Campaign* aimed at increasing the Bank's visibility and presence in the financial services marketplace;
- *Optimising the Use of Technology* to improve efficiency; and

– *Implementing an Effective Fee/Cost Recovery Structure as a cost containment strategy.*

It was in pursuance of the third strategic initiative listed when the EXIM Bank was seeking to formulate our 2010 Vision that two of the critical success factors were identified; the need to attract business from new industry sectors and sub sectors and the need to provide innovative products and services to our clients. We also took the decision to target a managed level of support to the creative industries, building on the specialized programmes of assistance that had already been designed for the technology sector.

One of our challenges, however, was that in initial exploratory meetings that were held with representatives from the areas of film, music and fine arts and to some extent, publishing, we were finding that there was limited capability to offer tangible assets as security, but a willingness to offer the intellectual capital inherent in their businesses. In other words, their IPRs were being offered as a substitute for real property.

Although prepared in principle to accept some amount of managed risk, EXIM Bank realized that we were ill-equipped to readily assess the risk inherent in taking that type of security and we therefore set about seeing how we could educate ourselves about IP and its possible utilization as loan security to facilitate the provision of financing.

We started with doing some research and canvassing our colleagues in the Berne Union (other Trade Credit Insurers worldwide) to find out which agency if any, provided funding using IP as the collateral security. The feedback from our enquiries was that none of them provide financing secured by IP.

Our approaches to the local banking sector also revealed that there was no isolation of IP as a collateral item that would generate its own financing stream. We were advised that if a line of credit is extended to a company and the security involves a debenture over the fixed and floating assets of the company, then by virtue of the all-encompassing nature of the debenture, any intellectual property rights owned by the company are captured. However, there is a reticence on the part of the financial institutions to single out and accept IPRs on their own as the security. I was advised by one senior banker that if they were to do that, in all likelihood they would totally discount the valuation and classify the particular loan as "unsecured."

At that point, not only would such lending fall within the various prudential limits laid down on how much of an entity's portfolio can be lent on an unsecured basis, but such facilities would then fall within the Capital Adequacy Regulations of the Banking Act and the Financial Institutions Act. Those regulations require that loans that are secured by such non-tangible assets such as IPRs carry a 100% risk classification and must be offset against the capital base of the entity[167]. Such offsets affect the capital adequacy strength of the institutions and could account for any reticence in moving towards that type of lending. Additionally, concerns were expressed about the capability in any event to recognise the value of any assigned IPRs in the balance sheet under the International Financial Reporting Standards.

[167] The Banking (Capital Adequacy) Regulations, 2004 and The Financial Institutions (Capital Adequacy) Regulations, 2004, at *http://www.boj.org.jm/supervised_legislation.php.*

We also contacted one of the two institutions we were able to identify worldwide that are currently using IP security for the extension of loans and guarantees, including SODEC in Quebec, Canada, and are still awaiting a response.

The Jamaica Intellectual Property Office (JIPO) facilitated a meeting with a Senior IP expert, Mr. Laurent Manderieux, who advised that unlocking the value in IP would generate significant interest over the next several years, but the apparent lack of appropriate legislative framework in the various countries would hamper growth and development. We were advised that only New Zealand is looking at introducing legislation on non-movable assets; so those countries that wanted to explore the possibilities would have to fit the initiative within current legislation.

That meeting spawned the idea to coordinate a public forum where we, other financial institutions and vested interest stakeholders could seek to ventilate the subject and educate ourselves so that we could move the process forward.

Having established a linkage with JIPO, we also approached other entities who would have requisite experience – the international consulting firm, Price Waterhouse Coopers (PwC) on the valuation side, and on the legal framework side, Foga Daley, a local legal firm specializing in IP - to suggest that they collaborate with us on an information sharing and fact-finding seminar. We also solicited the support of Jamaica's Investment Promotion Agency – Jamaica Trade and Invest – and all the responses were immediate and affirmative such that there was a jointly sponsored seminar titled, "Intellectual Property – Take it to the Bank!" held on July 9, 2008.

The seminar was extremely well attended by over 150 persons, giving credence to our belief that IP is a "hot button" subject and that many persons are interested in being educated about the protection of knowledge and creativity and their conversion into value. PwC brought down two of their IP experts from their New York Offices and Foga Daley shared with the audience the legislative framework within which funding using IP must operate.

In terms of the securitization or valuation of IP or intellectual assets (IA), the methodologies are clear-cut and proven in a financial arena[168].

Cost Approach

- Value based upon reproduction or replacement costs of asset, considering market acceptance and timing needs; and
- Often yields lowest value for an IA.

Market Approach

- Value based upon guideline transactions of comparable assets; and
- Often difficult to find relevant transactions matching appropriately with the technology, product, and industry application of IA.

[168] "How Much Are My Intellectual Assets worth?" Presentation by PwC New York Partner, Aron Levko, at the EXIM Bank Seminar – Intellectual Property- Take It To The Bank!, held July 9, 2008.

Income Approach

- Most common method for valuing IA;
- Value based upon expected future cash flows and related risk over the asset's life encompassed by the IA; and
- Types of income approaches include:
  Relief from Royalty Method (hybrid market/income);
  Profit Split Method;
  Excess/Incremental Profit Method.

The challenge for us is the establishment of proper values in the face of no proven historic data or valuation experts in a particular area. We are all no doubt acutely aware that in some instances, value can be extremely subjective.

Having at least sought to inform ourselves, the decision has been taken by the bank to support projects that have only IP to offer as the security. However, because of our limited experience in this area, we have not yet determined a prudential guideline as to how much we would discount whatever 'value' is put forward, or even whose assessment of value to accept. For example, when we lend using real estate or equipment as security we have a listing of approved valuators, we discount the values put forward as follows:

Residential Properties	70% of current market value
Residential Lots	50% of current market value
Commercial/Resort Properties	60% of current market value
Commercial Lots	50% of current market value
Agricultural Lands	50% of current market value
New Machinery and Equipment	60% of cost/current market value
Used Machinery and Equipment	50% of cost/current market value

Certainly in the current economic environment, our Credit Committee may even employ further discounts. In the case of IP values, we are not sanguine on what discount rate to employ.

EXIM Bank has what we call a Risk Capital Pool, where we have carved out a pool of funds, within the constraints of prudent risk management, that we are prepared to put at higher than normal risk. Projects that have only IP to offer as the security will be booked against that pool, but we have not determined what percentage of the pool will be exposed to IP projects.

In essence, although we say we are prepared to take the IPRs that may be identified in a particular situation, *de facto*, we are still hedging our risk by booking the loan against the Risk Capital Pool. As and when we gain more experience, we may abstain from employing any such risk mitigation strategy.

Another issue that is of concern for us in the banking arena is the secondary market for IA. Yes, one can possibly sell a piece of art, but there are instances in which one can envision that the value would only exist if it is inextricably tied to a particular entity or individual. When that linkage is untied, where is the value??

In the months since the holding of the seminar, the Bank engaged in extensive dialogue with various stakeholders in the Creative Industries to determine the feasibility of entering into risk sharing agreements with these stakeholders as a way of facilitating financial support to the Industry. So far one such agreement was approved to facilitate the manufacture of indigenous craft items for export. However these are essentially lent without any pretence at collateral security. They are predicated on the submission of confirmed orders.

As a test case for our lending and actually taking IP as security, the EXIM Bank opened discussions with the Jamaica Guild of Artists and after appropriate due diligence, were able to offer them a revolving line of credit, using the art pieces of the members as the security. The legal documentation that was used is a copyright mortgage and the valuation on the pieces was facilitated by PwC. Notwithstanding, we are still booking the facility against our risk capital pool.

We are currently in discussions with a Media Production company whose President came to our IP Seminar and recently approached us to “put up or shut up.” In other words, provide them with loan funds for some capital equipment they are trying to acquire and use the value inherent in their Film Archives to secure the facility. That will be another test case for us and we have asked them to find an independent authority to place a value on the film archive so the credit application can be reviewed with that in mind.

As a wholly government owned, economic development agency, one of the things EXIM Bank recognizes, and has never resiled from, is our responsibility to sometimes be on ‘the bleeding edge’, a step up from being on the cutting edge, if we can see the positive economic multiplier that could result after the pain. This is what we are trying to do in recognising the value inherent in the creativity of our people and who, in many instances, have nothing else to offer when trying to access financing. If we can be properly guided in the best way to help them “Take It To the Bank”, we would be satisfied that we are continuing to add value to Jamaica’s financial landscape.

CHAPTER VIII: IP FINANCING: THE BRAZILIAN EXPERIENCE WITH THE BRAZILIAN DEVELOPMENT BANK – BNDES

By Ms. Helena Tenório Veiga de Almeida

Innovation is the key word in the definition of country competitiveness and development. This is nothing new, for the Industrial Revolution showed the world the transformation capacity of innovation a long time ago. However, today we live in the knowledge era and innovation takes on an even more complex meaning. Innovation creates so-called intangible assets (brand, design, patents, R&D, IT processes, marketing, etc.), which more and more generate value within corporations and account for a considerable share of nations' wealth.

But what does the Brazilian Development Bank (BNDES) have to do with all this? Where is the "I" for innovation in BNDES' initials?

The answer is that BNDES has an important role to play in the spreading of innovation culture throughout Brazilian companies, and the "I", even if not spelled out, can be found in each one of the letters that make up the BNDES acronym. Let us analyze this more thoroughly:

BANK – *Financing is required in order to transform ideas into value. Equity is the most proper financial tool to risky investments (usually without tangible collateral).*

As with any other kind of investment, financing is an essential part of the innovation process. A Bank can make such resources available and manage risks by means of a varied portfolio. Financing innovation usually involves a higher risk and fewer guarantees because these types of investment generally do not build their own collaterals. Moreover, due to their intangible character, the investor needs to have a reasonable understanding of the company strategy. Thus, the most appropriate financial tool in this scenario is equity participation, directly or through investment funds.

BNDES has been a player in the capital market for a long time and now it holds shares in 186 companies and has created 35 venture capital funds of different kinds. These funds have already benefited more than 128 companies, and were able to leverage resources amounting to R$ 6.6 billion together with private partners, international organizations and pension funds. In 2008, 10 new funds were launched, of which three have already started choosing their investments. The aim is that small and medium-sized companies receive some support to their capital structure, that they are able to count on experienced advisers, and therefore that they are better prepared for sustainable growth, and also, according to other successful experiences, that they can make an Initial Public Offer successfully at BOVESPA MAIS or at NOVO MERCADO[169].

[169] Categories in Brazilian stock-market with higher levels of governance.

NATIONAL – *Fully harmonized with the Federal Government Industrial Policy*

Due to the fact that it plays an important role in the competitive ranking of a country, the incentive towards innovation should be a national project. In 2004, the Federal Government passed Law No.10.973, known as Innovation Law, which was a big step for the incentive of the public – private partnership for the generation of intellectual property ('IP'). The government innovation strategy is organized in the National Science, Technology and Innovation Policy (PACTI) and also integrated with another relevant national strategy - the Product Development Policy (PDP). These policies register the importance of innovation and of technological development for increasing competitiveness and for getting new markets, especially foreign ones.

ECONOMIC DEVELOPMENT – *Global competitiveness imposes constant changes upon countries' economies and their technological bases in order for them to keep on the path of growth and development.*

In order to be sustainable, economic development needs, besides promoting the growth of the economy and increasing the population's income, to provide the necessary institutional environment to keep up with the changes in a globalized world. Not developing the innovation capacity of an economy means losing competitiveness and falling behind in the economic development process. The strategy of absorbing mature technologies through machines and equipment, which was in place during the stage of import substitution industrialization, must be replaced in all sectors, with no exception. According to Professor Barros de Castro, innovation is a comprehensive phenomenon that should affect the economy as a whole. Furthermore, BNDES for its comprehensiveness and scale is more than able to be a leading facilitator of this process.

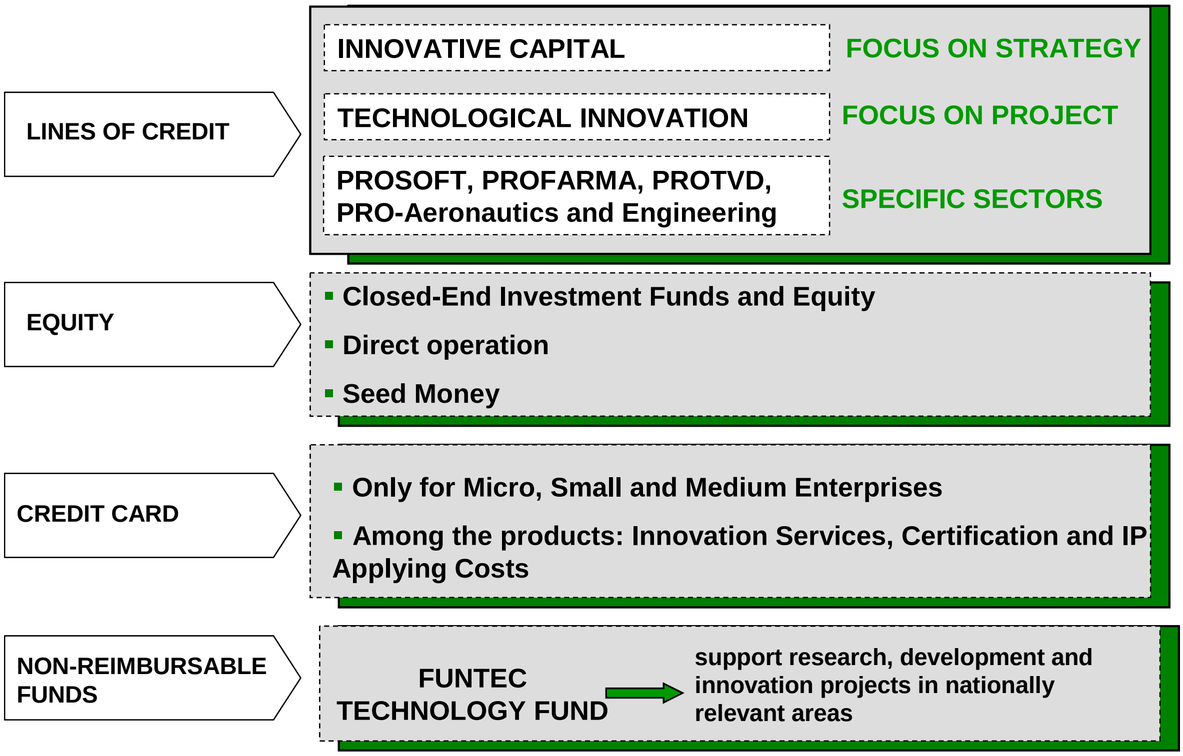
SOCIAL – *Innovation should not be restricted to large companies with respectable R&D departments. There are a huge number of SMEs and academic research centers full of innovative ideas which could be turned into successful entrepreneurships throughout Brazil, generating income and jobs.*

Finally there is the social development**.** Innovation is not restricted to big companies or groups with an international foothold. It is necessary to remove the elitism from the innovation process. There is a big space to be filled by fledgling technological companies and by academic research centers. In many countries like the United States, Israel and India, we find a growing concern with enabling this kind of entrepreneurship. There is also the worry of avoiding the "brain drain" from Brazil – a phenomenon that occurs when a generation of knowledge assets is not registered or does not belong eventually to its country of origin.
To sum up, development in the knowledge economy means promoting innovation, but commercial banks do not support innovation financing, so the Government bank must be prepared to finance innovation because:

– It is a political priority for the country;
– Resources must be available and financial instruments should be appropriate;
– It means an organizational cultural change;
– Risk analysis should be improved; and
– Technical competence is essential.

Within this context, BNDES has built its strategy of support or innovation. The aim of BNDES when it backs innovation is to contribute to the upswing of innovation activities in Brazil and to the performance of such activities on a regular basis. In order to do so, BNDES has support strategies which reach all sectors of economy, including the traditional ones. Such strategies match various financial instruments with credit or equity, and try to diminish the borrowers' difficulties, for instance, not making the existence of real guarantees necessary in some situations.

BNDES SUPPORT TO FINANCE INNOVATION - CHART



In 2006, after establishing support for innovation as one of its strategic priorities, BNDES created its first horizontal support lines. In this same year, FUNTEC – Technological Fund was launched aimed at supporting projects that would stimulate technological development and innovation of strategic interest for the country, in compliance with the programs and public policies of the Federal Government.

Early in 2008, aiming at reforming its support for innovation to better meet the needs of companies, BNDES created two new lines of credit replacing the two previously in place: the Innovative Capital Facility and the Technological Innovation Facility.

The Innovative Capital Facility aims to support companies in the development of capacity to undertake innovative activities on a regular basis. This includes investments both in tangible capital, including physical infrastructure, and in intangible capital. Such investments must be consistent with the companies' business strategies and be presented in accordance with the Innovation Investment Plan model.

The Technological Innovation Facility has the objective of supporting innovation projects of a technological nature that aim to develop new or significantly improved products and/or processes (at least for the domestic market) which involve technological risk and market opportunities.

FUNTEC (Technological Fund) is our non-reimbursable fund for supporting research, development and innovation projects in nationally relevant areas, and which allows Brazil to take strategic opportunities, and enables the country to take leading positions. The budget comes from BNDES' annual profits and each year the Board defines strategic areas to which to allocate grants. For 2008, the strategic areas were health, renewable energy and the environment (control of cars and plant emissions).

Due to the recognized importance of small innovative companies for the national development, both concerning job and income generation and also the production of new technologies, BNDES created the Criatec Program in 2007. Criatec is a seed money fund, focused on innovative fledgling companies, aiming to meet the needs of these companies for acquiring capital, because of the difficulty of having access to resources through traditional financing.

Throughout 2008, the Criatec Program selected seven regional managers: Belém, Ceará, Minas Gerais, Pernambuco, Rio de Janeiro, Santa Catarina and São Paulo. The geographical distribution of these program action sites through several different Brazilian regions, reflects the BNDES' effort to promote the access to its resources to companies from all over the country. The company portfolio of the Criatec Program includes 11 companies, with an average approved investment of R$1.4 million per company, amounting to a total of R$15.4 million.

Together with such financial support, the Criatec Program also gives management support to companies in order to better invest in the development of its entrepreneurial activities, contributing to the adoption of better governance practices, enhancing their chances of survival and of healthy growth. Besides the Criatec Program, BNDES supports the enhancement of innovation capability in small and middle-sized companies, both through direct investments – shareholding – and through indirect investments – venture capital funds.

Disbursements to innovation (2008)

US$ million

Lines of Credit	58
Specific Sector Programs	215
FUNTEC	33
Equity Participation (2007)	85
Investment Funds (2007)	150
New Machines to SMEs	418
Total	960

BNDES has begun to incorporate new methodology for the analysis of intangibles into its project analysis routine in order to better evaluate innovative projects

The fundamental question in the field of strategic management is how firms achieve and sustain competitive advantage. In the knowledge economy, intangible assets and competencies are the main tools to accomplish it. Therefore, valuation systems for intangibles are essential to support managers in the investment process.

The International Accounting Standard n.38/1998 has the following definition: "An intangible asset is an identifiable non-monetary asset without physical substance." Frequent examples refer to company capabilities and skills in activities like innovation, relationship with clients and suppliers, organization, planning and strategy implementation.

The central problem was that, according to the accounting rule, investments in intangible assets, particularly those built internally, are not fit for being entered in the company's accounting books. For this reason, companies that invest heavily in intangibles show, at least during their maturation period, accounting results which are lower than those that do not. This fact was impairing credit analysis by the Bank, and the result was that companies with a strong component of intangible assets were not eligible for obtaining financing from the Bank.

In the proposed model developed in consultation with CRIE/COPPE (Federal University of Rio de Janeiro), we decided to work with six capitals: (i) Strategic, (ii) Environmental, (iii) Relationship, (iv) Structural, (v) Human and (vi) Financial Capital.

(i) Strategic Capital is the means to sense and then to seize new opportunities (competitive intelligence, benchmarking, scenario analysis) and formulate the strategy to take the opportunities and minimize the risks. It is based on the concept of dynamic capabilities.

(ii) Environmental Capital is the dynamics of the location where the firm is embedded and its capacity for adaptation of knowledge.

(iii) Relationship Capital encompasses the assets: clients, suppliers, network, insertion in the market and trademarks.

(iv) Structural Capital is the basis for sustaining growth and incorporates processes, IT & C Systems, governance and research / development / and innovation (R&D&I) process (patents, registrations).

(v) Human Capital was addressed as one of the competencies expressed by knowledge, ability in executing and attitude of administrators and operators (collaborators).

(vi) Financial Capital is the company's competence to formulate and implement a financial strategy that optimizes results for the shareholder, through matching financing sources that do not unnecessarily dilute its shareholding interest and do not expose the company to risks through excessive indebtedness.

All such forms of capital are important, because they are intertwined and, depending on the sector cut or the stage of the industry or company, they become more or less important. In this sense, BNDES has already started making an effort to adopt the methodology of intangible asset evaluation as routine.

Gauging systems towards the assessment of these assets are being improved as a part of a new more comprehensive methodology: Company Quality Assessment Methodology, which also includes other fundamental issues for analysis of a company. Such methodology may be used for different purposes within BNDES, from the analysis of financing projects to rating calculation.

Conclusion

For all that has been described here referring to the actions implemented throughout the last years – which were triggered by the re-examination of BNDES' priorities, thus ranking innovation at the top of the list – the BNDES commitment with the "I" in innovation is evident.

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CHAPTER IX: INTERNATIONAL POLICY DEVELOPMENT ON IP FINANCING: UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW (UNCITRAL) LEGISLATIVE GUIDE ON SECURED TRANSACTIONS AND CURRENT WORK ON SECURITY INTERESTS IN IP RIGHTS

By Mr. Spiros Bazinas[*]

Security interests in intellectual property rights

1. Purpose of work

In December 2007, the United Nations Commission on International Trade Law (UNCITRAL) adopted the UNCITRAL Legislative Guide on Secured Transactions ("the Guide")[170]. The Guide includes commentary and legislative recommendations. It deals with security interests in tangible and intangible movable assets, including intellectual property ('IP') rights. However, to the extent that an issue is addressed by IP law (defined in a broad way to include national law and international treaties) in a different way than in the Guide, the Guide does not apply (see recommendation 4(b)).

To avoid inconsistencies with IP law and ensure better coordination between secured transactions and IP law, UNCITRAL decided to prepare an additional text supplementing the commentary and recommendations of the Guide as they apply to security interests in IP ("the Annex"). The overall objective of the Annex is to facilitate IP financing within the parameters of IP law. More specifically, the goal of the Annex is to allow authors and patent or trademark owners, but also licensors and licensees, to use their IP rights as security for credit, to the extent permitted under IP law. At the same time, the Annex is designed to allow secured creditors to obtain a security interest in an IP right, determine its priority and enforce it within the limits of IP law[171].

2. Scope of work

a. Assets and transactions covered

What is an IP right (e.g., patent, trademark or copyright) and whether it may be transferred is a matter of IP law. There is no overlap and no potential conflict with regard to secured transactions law.

To the extent an IP right, such as those held by a patent or trademark owner, a licensor or a licensee, may be transferred, the Guide and the Annex are based on the assumption that a security right may be created in that IP.

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[170] See Report of UNCITRAL on the work of its resumed fortieth session, A/62/17 (Part II), paras. 99-100. All the documents referred to in this article are available on the UNCITRAL website, at *http://www.uncitral.org.*

[171] See Draft Annex in A/CN.9/WG.VI/WP.37, paras. 47-53.

Transactions covered include all transactions that serve security purposes, no matter how they are denominated. As a result, for example, pledges, mortgages, trusts, security transfers are covered.

Outright transfers of IP are not covered, except to the extent that they compete with a security interest in an IP right, in which case the commentary and the recommendations of the Guide and the Annex dealing with priority conflicts apply.

b. Limitations

As already mentioned, in principle, the Guide applies to security interests in IP rights.

However, if secured transactions and IP law apply to the same matter and lead to a different result, the Guide does not apply, provided that the IP law rule is specific to IP rights (and not merely a general rule of secured transactions law which applies to IP rights as well) (see recommendation 4(b)). At the same time, mild suggestions are included in the commentary as to how States enacting the Guide and the Annex might better coordinate their IP law with their enactment of the Guide and the Annex.

As the Guide deals with the creation, third-party effectiveness, priority and enforcement of a security interest in an IP right and not with IP rights where no security issue is involved, there is no overlap and thus no conflict between the Guide and IP law with respect to the creation, effectiveness, priority and protection of an IP right.

It should be noted that the Guide and the Annex do not affect contractual limitations with regard to the transferability of IP rights or even of royalties (where the licensor prohibits the licensee from assigning to a third party sub-royalties owed to the licensee as a sub-licensor). The Guide only validates an assignment of receivables where the debtor (licensee) prohibits the creditor (licensor) from assigning its receivables to a third party (see recommendation 24).

It should also be noted that the Guide and the Annex do not override any statutory limitations (see recommendation 18), with the exception of statutory limitations relating to the assignability of future receivables or receivables assigned in bulk as such (see recommendation 23). This recommendation does not apply if the statutory limitation is based on the nature of the receivables, for example, as employment benefits rather than as future receivables only.

In addition, the general discussion and recommendations of the Guide apply to security interests in IP rights, as supplemented or revised by the specific discussion and recommendations of the Annex.

3. Creation and third-party effectiveness of a security interest in an IP right

a. Creation

In line with the approach followed in the Guide, the Annex draws a distinction between the creation and the third-party effectiveness of a security interest in an IP right. Briefly, the reason for this approach lies in the need to facilitate the creation of a security interest in an IP right, while at the same time reasonably ensuring the protection of third-party rights and establishing an objective system (based on registration) for the determination of priority between a secured creditor and a competing claimant[172].

As mentioned earlier, the Guide and the Annex do not deal with the creation of an IP right (which may include its effectiveness against third parties). This is exclusively a matter of IP law. They do deal with the creation of a security interest in an IP right and require a security agreement to reflect the intent of the parties to create a security interest, identify the secured creditor and the grantor, and describe the secured obligation as well as the encumbered asset in a manner that reasonably allows their identification (see recommendation 14). The last requirement typically refers to a general identification of the encumbered asset. It does cover though a more specific identification if it is required under a particular law and practice, such as IP law and practice.

As for any other asset, the grantor of a security interest in an IP right must have rights in the IP right and cannot encumber more rights than the grantor actually has (*nemo dat*).

Similarly, the grantor may create a security interest in a future IP right (see recommendation 17). In such a case, the security interest is created when the IP right arises (see recommendation 13). If, however, IP law does not permit the creation of a security interest in an IP right, the Guide and the Annex do not override that limitation (see recommendation 18).

b. Third-party effectiveness

As is the case with the creation of an IP right, its effectiveness against third parties (if a distinction is drawn between creation and third-party effectiveness) is exclusively a matter of IP law. The Guide and the Annex do address, however, the issue of the third-party effectiveness of a security interest in an IP right as a matter of secured transactions law[173]. The main rule is that a security interest in an IP right may be made effective against third parties by registration of a notice in a general security rights registry (see recommendation 32). The notice need contain only minimal information, such as the name of the grantor and the secured creditor (or the secured creditor's representative), a description of the encumbered asset, the duration of registration and, if required in a certain State, the maximum amount for which a security interest may be enforced (see recommendation 57).

The standard for the description of the encumbered asset in the notice is the same as mentioned above for the description of the encumbered asset in the security agreement and may vary depending on the requirements of a particular law or practice (see recommendation 63). Similarly, the notice may refer to future assets; unless this is not permitted under IP law (see recommendations 68 and 18).

To avoid undermining specialized registries, the Guide provides that a security interest may be made effective against third parties by registration in a specialized registry, if such a registry exists (see recommendation 38). This rule applies also to IP registries. What is registered exactly (that is, a document, a summary or a notice) is a matter of IP law. The Guide and the Annex assign third-party effectiveness to this registration, irrespective of what

[172] See Draft Annex in A/CN.9/WG.VI/WP.37/Add.1, paras. 26-28.
[173] See Draft Annex in A/CN.9/WG.VI/WP.37/Add.2, paras. 1-3.

are the legal consequences of registration under IP law, unless of course this is not permitted under IP law. The result of this approach is that, under a specific rule, priority is given to a security interest in an IP right with respect to which a registration has taken place in an IP registry (see recommendation 77(a)). This is the main way in which the Guide and the Annex coordinate between registrations in the general security rights registry and in an IP registry. However, the Guide and the Annex discuss other ways of coordination, such as asset-based and name based-indices and exchange of information between registries[174].

4. Priority and enforcement of a security interest in an IP right

a. Priority

Again, the Guide and the Annex do not deal with the priority of an IP right as between competing transferees and licensees. They do not deal with priority of rights as between a transferee or a licensee and an infringer either. These are exclusively a matter of IP law. The Guide and the Annex deal with priority conflicts only where a secured creditor competes with another claimant to obtain the economic benefit of its security interest in preference to that claimant. The main rule of priority under the Guide and the only such rule under the Annex are based on the registration of a notice of a security interest in a general security rights registry or in a specialized registry (see recommendation 76). The first secured creditor to register a notice of its security interest in the general security rights registry prevails. There is one exception. If a secured creditor registers a notice or a document of its security interest in an IP registry, then that secured creditor has priority (see recommendation 77(a)). This rule is designed to avoid undermining the reliability of IP registries, but does not recommend the establishment of such registries if they do not exist.

If an IP right is transferred and the transferor then creates a security interest, there is no issue of priority because there is no security interest, as the transferor does not have any rights to give to the secured creditor (*nemo dat*).

If, however, an IP owner creates a security interest in his/her IP right and then transfers it, the transferee takes the IP right subject to the security right (see recommendation 79). This means that, if the transferor defaults, the secured creditor enforcing the security interest may obtain the IP right and sell it or grant a licence in it.

There are two exceptions to this priority rule. A transferee or licensee of an IP right takes it free of a pre-existing security interest if:

(i) the secured creditor has authorized the transfer or licence free of the security interest (see recommendation 80); or

(ii) the transfer or licence is in the ordinary course of business of the transferor or the licensor and the transferee or licensee had no knowledge that the transfer or licence violated the rights of the secured creditor under the security agreement (see recommendation 81(c)). This last exception is the result of a long debate on the basis of the argument that there no ordinary-course-of business licences of IP. Furthermore, the Working Group is considering potential alternatives to the above-mentioned rule.

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[174] See Draft Annex in A/CN.9/WG.VI./WP.37/Add.2, paras. 15-19.

Finally, it is important to note that all these rules apply to security interests in IP rights only to the extent that IP law does not address them in a different way (see recommendation 4(b)).

b. Enforcement

As already mentioned, the Guide and the Annex do not deal with the enforcement of an IP right in the sense of the rightsholders enjoying the use and benefits of its right or enforcing its right against infringers. The Guide and the Annex deal with the enforcement of a security interest in an IP right addressing the remedies of a secured creditor in the case the grantor defaults.

Briefly, the main remedies of a secured creditor when a grantor defaults is to obtain control of the encumbered IP right and to sell it or license it on behalf of the grantor so as to satisfy from the proceeds of the sale or the licence royalties the secured obligation (see recommendation 141). The remedies may be exercised in court or out of court subject to adequate protection of the rights of the grantor and any other person with interests in the encumbered assets (see recommendation 137, 138 and 142). If there is a surplus, the secured creditor has to turn it over to the grantor (see recommendation 152). The person acquiring an IP right in the context of out-of-court enforcement of a security interest acquires it free of the security interest of the enforcing secured creditor and any other junior secured creditor but subject to any security interests that are senior to the security interest of the enforcing secured creditor (see recommendation 161). It is important to note that, in enforcing its security interest, the secured creditor has to act in good faith and in accordance with reasonable commercial standards (see recommendation 131).

Under the Guide and the Annex, the secured creditor does not become the owner of the encumbered IP right unless the secured creditor acquires the encumbered IP right in the context of enforcement (see recommendations 148 and 156). This approach does not interfere with the possible treatment of a secured creditor under IP law as an owner in the sense that the secured creditor may have the right to deal with Government Authorities, for example, to renew registrations, or to sue infringers.

5. Applicable law

The Guide and the Annex do not deal with the law applicable to ownership rights with respect to IP rights. They deal with the law applicable to the creation, third-party effectiveness, priority and enforcement of a security interest in an IP right.

Currently, the Annex discusses the commentary and presents a number of alternatives. One alternative is based on the approach in relation to the issue of the applicable law with regards to ownership rights. Under this approach, the law applicable to a security interest in an IP right should be the law of the State in which the IP right is protected. The main argument in favour of this approach is that it would result in the application of one and the same law to ownership rights and security interests in IP rights.

Another alternative is based on the law applicable, in the Guide, to security interests in intangible assets. It is the law of the grantor’s location (the grantor’s place of central administration or principal place of business). The main argument in favour of this approach is that it would result in the application of a single law, which in particular in the case of a security interest in a portfolio of IP rights would result in significant time and cost savings to create and enforce a security interest.

A third alternative is based on a combination of the first two alternatives referring to the law of the grantor's location some issues (for example, creation) and to the law of the State in which the IP right is protected other issues (for, example, third-party effectiveness and priority). The main argument for this approach is to obtain the benefits of the other two approaches[175].

6. The impact of the insolvency of a licensor or a licensee on security interests

Where a licensor becomes insolvent, the insolvency administrator may reject any contract that may not have been fully performed by both the insolvent debtor and his/her counterparty. If a licence agreement falls into that category, a licensee and any sub-licensee will lose its rights. In addition, a secured creditor of the licensor or licensee (or any sub-licensee) will lose its security. To address this situation, the Annex includes some discussion and makes a mild suggestion as to how secured creditors and licensees may be protected.

Similarly, where a licensee becomes insolvent, the licence becomes part of the estate and the licensor may not be able to separate it. If the insolvent licensee has given a security interest in sub-royalties out of which the licensor would be paid, the licensor may not have priority and lose even the royalties. For these reasons, the Annex discusses the rights of a licensor to request from the insolvent licensee that any default in the payment of royalties by the estate be cured and if this does not happen to terminate the licence agreement. The Annex also discusses the right of the licensor to seek relief from the insolvency court where there is discontinuation of payment of royalties because of priority given to secured creditors or other relief to protect the IP right[176].

As these issues touch on insolvency law, they are being discussed by both the Insolvency and the Security Interests Working Groups of UNCITRAL and will have to be resolved in line with the UNCITRAL Legislative Guide on Insolvency Law.

7. Conclusions

The Guide and the Annex are designed to facilitate IP financing, without interfering with IP law. This result is achieved by commentary and recommendations that deal with the creation, third-party effectiveness, priority, enforcement (even within insolvency) of a security interest in an IP right, as well as with the law applicable to such matters.

The commentary explains how the recommendations of the Guide and the Annex would apply in the context of an IP financing transaction. They do so in a way that ensures better coordination between secured transactions and IP law. With the same goal in mind, the recommendations of the Annex modify the general recommendations of the Guide as they apply to security interests in IP rights. Mild suggestions are also included in the Guide as to how States that may wish to enact the Guide and the Annex could coordinate their IP laws with the Guide and the Annex. The integrity of IP law is finally preserved through a general

[175] See Draft Annex in A/CN.9/WG.VI/WP.37/Add.4, paras. 1-21.
[176] See Draft Annex in A/CN.9/WG.VI/WP.37/Add.4, paras. 22-40.

rule that gives precedence to IP law where it deals in an asset-specific and different way with any matter addressed in the Guide and the Annex.

The creation of a security interest in an IP right is simplified by requiring only a written security agreement. At the same time, the rights of third parties are protected by third-party effectiveness requirements that refer to the registration of a notice of a security interest in an IP right in the general security interests registry (or, if there is a specialized IP registry, in that registry).

Similarly, the interests of competing claimants are protected by determining priority on the basis of the time of registration of a notice of the security interest in the general security interests' registry, with appropriate exceptions.

A comprehensive set of enforcement provisions in the Guide and the Annex is designed to ensure certainty as to the remedies of the secured creditor in the case of default with due protection of the rights of the grantor and other parties with interests in the encumbered IP.

Discussion of insolvency-related issues is intended to supplement the regime of security interests in IP with analysis of the impact of insolvency on the rights of secured creditors of an insolvent licensor or licensee.

Finally, the discussion of applicable law issues completes the treatment of security interests in IP rights in the Guide and the Annex in a practical way that will be consistent with IP law.

CHAPTER X: THE UNCITRAL LEGISLATIVE GUIDE ON SECURED TRANSACTIONS: AN INTRODUCTION AND OVERVIEW

By Professor Neil Cohen

I. The Function of Secured Credit

Over the last century, economic activity has been transformed in many ways. In one transformation, the subjects of economic activity have evolved as nations move from goods-based economies, to economies based on goods and services and, most recently, to goods, services, and information. The last development, of course, is the development that has given rise to this seminar.

A second transformation, while less noted, has also been of major importance. That transformation, longer in the making but greatly accelerated in the last century, is from cash-based economies to credit-based economies. As Daniel Webster stated in 1834:

> Credit is the vital air of the system of modern commerce. It has done more, a thousand times, to enrich nations, than all the mines of all the world. It has excited labor, stimulated manufactures, pushed commerce over every sea, and brought every nation, every kingdom, and every small tribe, among the races of men, to be known to all the rest. It has raised armies, equipped navies, and, triumphing over the gross power of mere numbers, it has established national superiority on the foundation of intelligence, wealth, and well-directed industry. Credit is to money what money is to articles of merchandise. As hard money represents property, so credit represents hard money.[177]

What makes this "vital air" happen?

In a nutshell[178], credit transactions, like all transactions occur only if they are seen as profitable for both parties. From the perspective of the creditor, the analysis is simple. The profits generated by an extension of credit may be direct, deriving from interest charges in excess of the creditor's time value of money, or indirect, financing profitable transactions (such as the sale of goods by the creditor or the license of intellectual property by the creditor) that might not otherwise occurred. Many credit transactions generate profits in both of these ways – enabling a profitable transaction that may not otherwise have taken place and making a separate profit from the interest charged to the customer.

From the perspective of the debtor, the transaction must be profitable as well. The analysis is simple. A debtor will not enter into a credit transaction unless the value to it of the funds obtained or other credit extended is greater than the cost of the credit. By way of example, a debtor who is seeking to obtain 10,000 Euros to invest in the purchase of a piece of equipment that will generate an 11% return on investment (before taking interest into account) will borrow the 10,000 Euros if

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[177] The Writings and Speeches of Daniel Webster, vol. 7, p. 89 (1903).

[178] For additional exploration of this topic, see, e.g., Neil B. Cohen, Internationalizing the Law of Secured Credit: Perspectives from the U.S. Experience, 20 U. Pa. J. Int'l Econ. L. 423 (1999); Neil B. Cohen, Credit Enhancement in Domestic Transactions: Conceptualizing the Devices and Reinventing the Law, 22 Brook. J. Int'l L. 21 (1996).

the interest rate is 9% (because the transaction will be profitable inasmuch as the return on the borrowed funds will be greater than their cost), but will not borrow the money if the interest rate is 13% (because the transaction will not be profitable inasmuch as the cost of the funds will be greater than the return derived from them).

The difficulty, of course, is that the profitability analysis for creditors tends to move in the opposite direction from the profitability analysis for debtors; increasing the interest rate makes it more likely that the transaction will be profitable for the creditor but less likely that the transaction will be profitable for the debtor, and *vice versa*. More particularly, from the perspective of the creditor, determination of whether a credit transaction is likely to be profitable requires consideration not only of the creditor's cost of funds and the interest rate provided for in the credit contract but also of the possibility of loss because the debtor breaches the contract and does not repay the debt. Individual extensions of credit are obviously profitable for creditors only when the debtors pay their debts. Those who extend credit repeatedly can profit despite a small number of defaulting debtors, but will not profit in the aggregate if too many debtors fail to pay their debts. Indeed, the loss associated with one defaulting debtor is typically several times larger than the profit generated by a fully performing debtor. Thus, a single default can eliminate the profits generated by a large number of fully performing extensions of credit.

If creditors could predict which debtors would default and which would not, life would be simple; credit would be extended to the latter group but not the former. Unfortunately, such predictions are not possible for most debtors; the best that creditors can do is to assess imperfectly the probability that a particular debtor (and those of similar characteristics) will default. The higher the projected number of defaults for a particular class of debtors, the more that must be charged for loans to such debtors, because the additional charge paid by performing debtors will make up for the loss associated with the defaulting debtors. At some point, the projected losses are so high that the creditor will simply not extend credit at all. Short of that point, though, the result is that higher perceived risk of default results in higher interest rates because higher rates are necessary in order for the creditor to project that a class of transactions will be profitable.

As noted above, though, the interest rate also determines whether a particular credit transaction will be seen as profitable by the debtor. If the interest rate is too high, an otherwise-profitable transaction will be unprofitable for the debtor and will not occur.

Accordingly, the level of risk associated with a transaction desired by both parties will often determine whether the transaction will go forward. If the level of risk is too high, the transaction will not go forward because the interest rate needed by the creditor in order to project a profit will be so high that the transaction cannot be seen as profitable by the debtor.

If the level of risk associated with the transaction were lower, though, the transaction could go forward because the interest rate needed by the creditor could be low enough to enable the debtor to achieve profits on the transaction.

What can lower the risk associated with a particular transaction, so that it can be priced in a way that leads to profits for both parties? One way is for another person, more creditworthy than the debtor, to agree to be liable for (or with respect to) the debtor's obligation. This lowers the risk of loss from the creditor's perspective because the creditor can turn to the more creditworthy obligor in the event of the debtor's default. This can be effectuated, among other ways, through a personal guaranty, a suretyship contract, a standby letter of credit, or an independent guaranty.

A second way to lower risk of creditor loss upon debtor's default, and the focus of this seminar, is through the use of collateral – that is, by the creditor being granted a security interest in some or all of the debtor's property. When a debtor grants a creditor a security interest in some of the debtor's property, the debtor is, essentially, agreeing that, if the debtor defaults, the creditor will be entitled to seize that property, dispose of it, and use the proceeds of the disposition to satisfy the debt. When the grant of the security interest is effectuated properly, it is effective not only between the debtor and creditor but also against third parties. Most third parties who obtain an interest in the property thereafter will be subordinate to the rights of the creditor.

Just as economic activity has migrated from goods to services and information, transactions in which property serves as collateral have similarly developed, from an early focus primarily on goods as collateral to a more recent trend increasingly to utilize intangible property as collateral. One form of intangible property that achieved early importance as the basis for extending credit is receivables. Nineteenth century recognition of the importance of receivables is evidenced by the Scottish economist Henry Dunning McLeod, who stated in 1872, "If it were asked, what discovery has most deeply affected the fortunes of the human race it might probably be said with truth – The discovery that debt is a saleable commodity[179]." As secured transactions have developed since the nineteenth century, debt – *i.e.*, receivables – has become the basis not only of sales but also important collateral for loans. Of course, other types of intangible property – notably intellectual property – now provide a strong basis for credit as well.

II. The UNCITRAL Legislative Guide on Secured Transactions

With this background, let us turn to the UNCITRAL Legislative Guide.

A. The Approach of the UNCITRAL Legislative Guide

As stated by UNCITRAL, the purpose of the *Legislative Guide on Secured Transactions* (hereinafter referred to as "*the Guide*") is "to assist States in developing modern secured transactions laws 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."

Consider the following excerpts from the Introduction to the Guide, setting out its purpose:

> The *Guide* is based on the premise that sound secured transactions laws can have significant economic benefits for States that adopt them, including attracting credit from domestic and foreign lenders and other credit providers, promoting the development and growth of domestic businesses (in particular small and medium-sized enterprises) and generally increasing trade. Such laws also benefit consumers by lowering prices for goods and services and making consumer credit more readily available.
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> The *Guide* seeks to rise above differences among legal regimes to offer pragmatic and proven solutions that can be accepted and implemented in States with divergent legal traditions (civil law, common law and Chinese, Islamic and other legal traditions) and in

[179] H.D. McLeod, Principles of Economical Philosophy 481 (2d ed. 1872).

> States with developing or developed economies. The focus of the *Guide* is on developing laws that achieve practical economic benefits for States that adopt them.
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> All businesses, whether engaged in mining, lumbering, manufacturing, distributing, providing services or retailing, require working capital to operate, to grow and to compete successfully in the marketplace. It is well established, through studies conducted by such organizations as the International Bank for Reconstruction and Development (IBRD), the International Monetary Fund (IMF), the Asian Development Bank (ADB) and the European Bank for Reconstruction and Development (EBRD), that one of the most effective means of providing working capital to commercial enterprises is through secured credit.
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> The key to the effectiveness of secured credit is that it allows businesses to use the value inherent in their assets as a means of reducing risk for the creditor. Risk is reduced because credit secured by assets gives creditors access to the assets as another source of recovery in the event of non-payment of the secured obligation. As prospective creditors perceive that this risk of non-payment is reduced in a proposed credit transaction, they are more likely to be willing to extend credit and to increase the amount or reduce the cost of the credit they provide.
>
> A legal system that supports secured credit transactions is critical to reducing the perceived risks of credit transactions and promoting the availability of secured credit generally. Secured credit is more readily available to businesses in States that have efficient and effective laws that provide for consistent, predictable outcomes for secured creditors in the event of non-performance by debtors. On the other hand, in States where the absence of such laws means that creditors perceive the risks associated with credit transactions to be high, the cost of credit normally increases, as creditors require increased compensation to evaluate and assume the increased risk. In some States, the absence of an efficient and effective secured transactions regime or of an insolvency law regime under which security rights are recognized, has resulted in the virtual elimination of credit for small and medium-sized commercial enterprises, as well as for consumers.
>
> By aiding in the cultivation and growth of individual businesses, a legal regime that promotes secured credit can also have a positive effect upon the general economic prosperity of a State. Thus, States that do not have an efficient and effective secured transactions regime may deny themselves valuable economic benefits.

How does the Guide effectuate those goals? The remainder of this paper provides a brief summary of the Guide.

B. Scope of Legal Regime Recommended by the Legislative Guide

The Legislative Guide recommends the enactment of a broad secured transactions regime. The regime should cover "all rights in movable assets created by agreement that secure payment or other performance of an obligation, regardless of the form of the transaction, the type of the movable asset, the status of the grantor or secured creditor or the nature of the secured obligation[180]." While there are some exclusions from this broad scope, they are minimal. The exclusions are for securities, payment rights arising under or from financial contracts governed by

[180] See Legislative Guide Recommendation 2.

netting agreements, payment rights arising under or from foreign exchange transactions, and mobile equipment covered by a national law or an international agreement to which the enacting State is a party, but only to the extent addressed in that national law or international agreement[181].

While the legal regime recommended by the Legislative Guide would cover security rights in intellectual property, the broad reach of the Legislative Guide is tempered by paragraph (b) of Recommendation 4: "[The law should not apply to] 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, the legal regime envisioned by the Legislative Guide would defer to existing law relating to intellectual property when that law would lead to a different result. UNCITRAL's current project to prepare a Supplement to the Legislative Guide dealing with security rights in intellectual property elaborates substantially on this point.

In addition to covering rights in personal property that secure payment or performance of an obligation, the legal regime recommended by the Legislative Guide also covers outright transfers of receivables. In this regard, the Legislative Guide follows the precedent of the United Nations Convention of the Assignment of Receivables in International Trade.

The scope of the legal regime recommended by the Legislative Guide cannot be fully comprehended, though, without appreciation of the functional approach that it takes. As stated in Recommendation 2, the regime would apply to all rights securing payment or performance of an obligation regardless of the form of the transaction. Thus, the coverage by the law of a transaction in which movable property secures an obligation cannot by avoided by choosing a form of the transaction that avoids using language referring to collateral and the like. Any right securing payment or performance of an obligation is defined as a "security right" by the Legislative Guide, "regardless of whether the parties have denominated it as a security right." Thus, the term is used functionally and its applicability does not depend on the language used by the parties.

The broad, functional approach of the regime recommended by the Legislative Guide does not mean that all transactions within its scope are subject to identical rules. Rather, the Legislative Guide recommends several asset-specific rules for particular types of assets serving as collateral, and identifies a few types of transactions, such as those in which the encumbered asset secures the obligation incurred to pay for it, to which special rules apply.

C. Creation of Security Rights

Similar to the functional approach to scope of the legal regime recommended by the Legislative Guide, which de-emphasizes formalism, the Legislative Guide recommends that security rights can be created by parties with a minimum of formalism. A security right in an asset is created "by an agreement concluded between the grantor and the secured creditor." No specific words must be used. Rather, the regime that is recommended requires only that the agreement reflect the intent of the parties to create a security right, identify the secured creditor and the grantor, describe the secured obligation, describe the encumbered assets in a manner that reasonably allows their identification[182]. In addition, the Legislative Guide recommends that the security agreement state the maximum monetary amount for which the security right may be enforced, if the enacting State determines that to be helpful in order to facilitate subordinate lending. The security

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[181] See Legislative Guide Recommendation 4.
[182] See Legislative Guide recommendation 14.

agreement must be in writing unless it is accompanied by the secured creditor's possession of the encumbered asset[183].

Importantly, a security right may secure any type of obligation, whether existing or arising in the future[184]. In addition, a grantor may create a security right not only in existing assets but also in future assets, and may create a security right in parts of assets and in undivided interests in assets[185].

The Legislative Guide also recommends that the secured transactions regime provide that proceeds of encumbered assets are also collateral for the secured obligation[186]. "Proceeds" is defined broadly to include "whatever is received in respect of encumbered assets, including what is received as a result of sale or other disposition or collection, lease or licence of an encumbered asset, proceeds of proceeds, civil and natural fruits, dividends, distributions, insurance proceeds and claims arising from defects in, damage to or loss of an encumbered asset." Thus, for example, if a secured creditor has a security right in a grantor's equipment, and that grantor sells that equipment to a buyer on credit, creating a receivable, the receivable constitutes proceeds in which the secured creditor has a security right.

When the security right is in a trade receivable (i.e., a receivable arising from a contract for the supply or lease of goods or services or the sale, lease, or license of intellectual property, etc.), the legal regime recommended by the Legislative Guide provides that the security right is effective notwithstanding any anti-assignment clause in the contract creating the receivable[187].

D. Effectiveness of a Security Right Against Third Parties

The Legislative Guide makes an important distinction between *creation* of a security right, which makes the right effective as between the grantor and the secured creditor, and enforceability of the security right as against third parties. The distinction has great practical importance because the economic value of collateral to a secured creditor depends not only on the secured creditor being able to have superior rights to those of the grantor to reach the value of the encumbered assets but also on the secured creditor being able to exercise its rights even when other parties – such as judgment creditors, other secured creditors, buyers of the encumbered assets from the grantor, and an insolvency administrator – are also claiming rights in the encumbered assets.

While, as described above, the Legislative Guide recommends a minimum of formalism for the creation of security rights, it recommends that the legal regime provide that the secured creditor must take important additional steps in order for its security right to be effective against third parties.

Several methods of achieving third-party effectiveness are provided by the recommendations of the Legislative Guide. When the encumbered assets are tangible, such as goods, the Legislative Guide provides that the secured creditor may make its security right effective against third parties by taking possession of the assets[188]. This method, commonly known as the "pledge," has great

[183] See Legislative Guide Recommendation 15.
[184] See Legislative Guide Recommendation 16.
[185] See Legislative Guide Recommendation 17.
[186] See Legislative Guide Recommendation 19.
[187] See Legislative Guide Recommendation 24.
[188] See Legislative Guide Recommendation 37.

historical provenance but limited present utility. First, this method of third-party effectiveness is available only with respect to tangible collateral. (This is because the Legislative Guide uses the term "possession" to refer to actual physical possession of an asset, which is possible only for tangible assets. Concepts of fictive or constructive possession are rejected.) Second, even with respect to tangible collateral, possession by the secured creditor is impractical for most types of business property inasmuch as a business debtor typically needs access to its property in order to generate the income that will be used to satisfy the secured obligation.

The most important, and certainly the most likely to be used, method of achieving third-part effectiveness in the legal regime recommended by the Legislative Guide is the registration of a notice with respect to the security right in a publicly accessible registry[189]. It should be noted that this is not the same thing as recordation of the security agreement itself, reminiscent of requirements for recordation of documents that fulfill various roles in many legal regimes. Rather, the recommendation here is for a notice containing relatively minimal information about the security right to be registered. In particular, the notice would require only the grantor's name, a description of the encumbered assets, and the duration of registration[190]. In addition, if the enacting State determines that this would be helpful in order to facilitate subordinate lending, an additional requirement that the notice disclose the maximum amount secured by the security right may be established. In describing the encumbered assets in the notice, detail is not required. Rather, all that is required is that the encumbered assets be described in a manner that reasonably allows their identification[191].

Under the regime recommended by the Legislative Guide, the key item in the notice to be registered with respect to a security right is the grantor's name or other identifier. Unlike patents and the like, which can always be described by a unique number, and property such as immovable property, that in many jurisdictions has a unique description or identification, most assets that may be the subject of security rights can be described in innumerable ways. Accordingly, the way that those seeking information from the registry in order to determine whether to enter into transactions with the grantor are likely to seek information from the registry is to seek to view all registered notices that list the grantor as grantor. Then, having obtained those notices, the information-seeker can examine the description of collateral in each notice and decide whether or not to go forward with the transaction. As a result, it is anticipated by the Legislative Guide that the notices in the registry will be indexed by the name of the grantor. Accordingly, it is very important that the grantor's name be indicated correctly in the notice[192].

Unlike many recording offices in many States, the registry foreseen by the Legislative Guide would not be an income-producing activity for the state. Rather, the Legislative Guide provides that fees for registration and for searching, if any, should be set at a level no higher than necessary to permit cost recovery[193].

In some situations, the Legislative Guide also provides for methods of achieving third-party effectiveness other than possession and registration of a notice. For example, in the case of assets with respect to which, under the law of a particular state, interests may be noted on a certificate of

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[189] See Legislative Guide Recommendation 32.
[190] See Legislative Guide Recommendation 57.
[191] See Legislative Guide Recommendations 14 and 63.
[192] See Legislative Guide Recommendations 58-60.
[193] See Legislative Guide Recommendation 54(i).

title or registered in a specialized registry that has third-party effects, the Legislative Guide recommends that such notation or registration will make the security right effective against third parties[194]. Also, when the encumbered asset is a bank account, the regime recommended by the Legislative Guide would provide that the security right may be made effective against third parties by "control[195]."

E. Priority of a security right as against competing claimants

As noted previously, when a secured creditor seeks to exercise its rights upon the default of the grantor, there may be other parties, such as competing secured creditors, judgment creditors, buyers, and even a bankruptcy trustee or insolvency administrator, who also have claims to the encumbered asset. If the encumbered asset is so valuable that it will generate sufficient funds upon disposition to satisfy the claims of all claimants, the multiplicity of claims may not cause a problem, but that is a relatively uncommon occurrence. More often, the order of priority of the various claims to the grantor's assets is critical in determining which parties will be able to obtain full or partial satisfaction of their claims from the encumbered assets. The basic priority rules recommended by the Legislative Guide are quite simple.

As between two competing secured creditors, both of whose security rights are effective against third parties, the secured creditor whose security right was first either the subject of a registered notice or otherwise made effective against third parties has priority over a secured creditor whose right was registered or otherwise made effective against third parties subsequently[196]. One important exception to this general rule relates to security rights in assets that may be noted on a certificate of title or registered in a specialized registry. With respect to such assets, a security right so noted or registered has priority over a competing security right that is not so noted or registered. A second important exception relates to acquisition security rights (*i.e.*, security rights in encumbered assets that secure the grantor's obligation to pay for the asset). In most cases, an acquisition security right has priority over a non-acquisition security right (regardless of the order of registration or third-party effectiveness) so long as the holder of the acquisition security right took certain steps in conjunction with obtaining the security right[197].

With respect to judgment creditors, the Legislative Guide provides that a security right has priority as against the rights of a judgment creditor, unless the creditor obtained its judgment or against the grantor and took the steps necessary to acquire rights in assets of the grantor by reason of the judgment before the security right was made effective against third parties[198].

With respect to transferees, the Legislative Guide recommends that the secured transactions regime provide that if an encumbered asset is transferred, leased or licensed and a security right in that asset is effective against third parties at the time of the transfer, lease or license, a transferee,

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[194] See Legislative Guide Recommendation 38.
[195] See Legislative Guide Recommendation 49.
[196] See Legislative Guide Recommendation 76.
[197] See generally, Legislative Guide Chapter IX. This chapter, the details of which are beyond the scope of this paper, was one of the more difficult chapters about which to achieve consensus. One result of that difficulty is that the chapter is presented in two alternative forms, with one of the alternatives tailored for states who would like to retain the structure of a retention of title regime rather than replace such a regime with the general secured transactions law.
[198] See Legislative Guide Recommendation 84.

lessee or licensee takes its rights subject to the security right[199]. This rule, however, is subject to an important set of exceptions. With respect to tangible assets, the Legislative Guide provides that a buyer of a tangible asset (other than a negotiable instrument or negotiable document) sold in the ordinary course of the seller's business takes free of a security right in the asset, provided that, at the time of the sale, the buyer does not have knowledge that the sale violates the rights of the secured creditor under the security agreement[200]. Similar protections are provided for lessees and non-exclusive licensees of encumbered assets.

F. Enforcement of Security Rights

As noted earlier, the economic value of a security right comes from the ability to enforce it in order to obtain satisfaction of an obligation. Under the law of many states, a security right is enforced by action of the state – a judicial proceeding (or the like) is required in order for the encumbered asset to be obtained from the grantor and the encumbered asset is disposed of in a judicial proceeding or under the supervision of the court.

The Legislative Guide does not follow this traditional model. Rather, the regime contemplated by the Legislative Guide provides for non-judicial enforcement by the secured creditor as well. When the collateral is in the possession of the grantor, the Legislative Guide provides that the secured creditor may obtain possession of the collateral without applying to a court if the grantor has consented to this method in the security agreement, the secured creditor has given the grantor notice of default and of intent to obtain possession, and the grantor does not object when the secured creditor seeks to obtain possession[201].

More importantly, the Legislative Guide provides for extrajudicial disposition of encumbered assets by the secured creditor. After default, a secured creditor is entitled, without judicial process, to sell or otherwise dispose of an encumbered asset. So long as the secured creditor acts in good faith and in a commercially reasonable manner, the secured creditor may select the method, manner, time, place and other aspects of the disposition[202].

[199] See Legislative Guide Recommendation 80.
[200] See Legislative Guide Recommendation 81(a).
[201] See Legislative Guide Recommendation 147.
[202] See Legislative Guide Recommendations 131 and 148.

CHAPTER XI: PERSONAL PROPERTY SECURITIES REFORM – THE AUSTRALIAN EXPERIENCE

By Mr. Robert Patch

Synopsis

Australian personal properties securities law is set to undergo significant reform in 2010. An exposure draft Personal Property Securities Bill aims to introduce a single national law and online national register for secured transactions based on a functional approach. PPS reform entails a substantial commitment to reform from the Government. The reforms have benefited from a range of views across industry, consumer representatives, academia and government. The financial sector supports the reforms and is looking to the government to settle the detail. There has been considerable debate about the detail of the proposed law and register design. Reconciling sectional interests has been no small endeavour. Overall, the reforms will improve certainty and consistency, while reducing complexity and cost for financiers, buyers and suppliers. National IP laws will continue to govern the creation of IP rights such as patents, trade marks, designs, plant breeder's rights, copyright and circuit layouts.

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Introduction

A significant proportion of individual and business wealth in Australia is held in personal property, with an increasing proportion found in intangible assets such as intellectual property (IP) rights. Australia has embarked upon ambitious reforms to Australian finance law, to ensure that individuals and businesses can harness the full value of their property. With the growing importance and value of IP rights, it is desirable that the law promote this asset class as a means of leveraging finance. As with approaches taken in the US, Canada and New Zealand, Australian personal properties securities (PPS) reform takes a functional approach to security interests. For the most part, the reform treats IP rights in the same way as any other forms of personal property.

This paper canvasses the Australian experience in PPS reform, including in relation to IP rights. Part A outlines the operation of the existing legal framework; Part B provides an overview of Australian PPS reforms; Part C provides an overview of the approach taken by the Australian Government in advancing the reform; and Part D discusses specific issues encountered in the reform process.

A key message from the Australian experience is that PPS reform is not to be embarked upon lightly. Support from the finance sector is central to success of the reform. Consultation and education plays a key role in advancing the reform. Reforms are inevitably tailored to accommodate stakeholder concerns. There is no “one size fits all” model for personal property securities reform. Stakeholders sometimes hold competing views that can be difficult, and sometimes impossible, to reconcile. While establishing a Personal Property Securities Register is uncontroversial, the design can be substantially altered by finer detail of the law and stakeholder concerns.

Part A – The Problem

Certainty, Consistency, Complexity, Cost

The current law and arrangements for the regulation of PPS in Australia are unsatisfactory in a modern national economy. More than 70 pieces of Commonwealth, State and Territory legislation operate alongside complex common law and equitable principles to provide a system that operates in different ways at different levels. In particular, PPS law and arrangements vary according to the location and nature of the collateral, the nature of the security interest, and the legal personality of the grantor (for example, whether the grantor is a corporation or an individual). These artificial distinctions are widely regarded as immaterial to the substance of secured transactions.

Across the nine Australian jurisdictions, more than 40 registers relating to security interests in personal property operate independently of each other. There is a national register of company charges (which applies, among other things, to charges in specified IP rights) as well as separate national IP registers that allow the recording of secured transactions affecting registered IP rights. For other forms of personal property, various registers cover bills of exchange, security interests in motor vehicles, primary produce liens and other security arrangements. The proliferation of registers has created duplication as well as gaps. For example, registration may be mandatory under one scheme, voluntary under another and, for other interests, there may be no specific register at all. These problems are endemic across the spectrum of Australian finance law.

This decentralized and inconsistent approach to the registration of security interests in personal property creates unnecessary uncertainty and complexities for borrowers and lenders. As a consequence, transaction costs (such as legal fees and registration and search costs) for both lenders and borrowers are unnecessarily high. In short, the present laws increase costs and risks for financiers, and therefore limit the availability of credit.

IP and security interest transactions

In Australia, IP rights are recognised as personal property capable of attracting security interests. There are six Commonwealth Acts dealing respectively with patents, trade marks, designs, plant breeder's rights, circuit layouts and copyright[203]. There is a relatively high degree of consistency across the IP Acts generally. However, there are some significant differences in their approach to security interests in IP.

The Patents Act, Trade Marks Act, Designs Act and Plant Breeder's Act establish a specialist national register. The Patents Act and Designs Act allow any interested party to record any form of interest (except trusts) in the patents and designs registers respectively. The Trade Marks Act only allows the owner to record interests in the trade marks register; no particulars of the type of interest are recorded. The Plant Breeder's Act only allows the registration of title; it does not allow the recordation of interests.

There are no specific registers for circuit layouts and copyrights.

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[203] *Patents Act 1990* (Cth), *Trade Marks Act 1995* (Cth), *Designs Act 2003* (Cth), *Plant Breeder's Rights Act 1994* (Cth), *Circuit Layouts Act 1989* (Cth) and *Copyright Act 1968* (Cth). Other IP rights, such as unregistered common law marks and goodwill, are not specifically regulated by statute.

There are also some other issues that are common for patents, registered trade marks and designs. Specifically, the registered owner of these IP rights may deal with the IP right as its absolute owner and give good discharge for any consideration provided for any such dealings. This is “subject only to any rights appearing in the Register to be vested in another person[204].” The protection provided by the register is afforded to *purchasers*, but not others, who deal with the registered owner[205]. The IP registers are *prima facie* evidence of interests and ownerships registered in it, but recordation of interests are only voluntary. Furthermore, the presumption may be rebutted by production of further evidence.

“Equities” in relation to a patent, trade mark or design may be enforced against the owner except to the prejudice of a purchaser in good faith for value[206]. However, it is not clear what the “equities” are that may be enforced against a registered owner, and particularly whether a security interest is an equity.

The *Corporations Act 2001* (Cth) operates alongside the IP Acts. The Corporations Act compels registration of security interests over assets of a company in the Australian Register of Company Charges[207]. Registration requirements apply equally to charges over all the company’s assets (including IP rights), and to charges over specific assets such as patents, trade marks, designs and copyright. However, the *Corporations Act* does not specifically require registration of charges over plant breeder’s rights or a circuit layout, other than in the context of a charge over all of the company’s assets. Failure to register within the statutory period will result in the charge being void in certain circumstances[208].

The result is that, in order to ensure validity, a charge granted by a company over patents, trade marks, designs and copyright should be registered under the Corporations Act, while there is no corresponding registration requirement for charges granted by an individual. The priority rules established by the *Corporations Act* apply subject to the *Copyright Act*, *Designs Act*, *Patents Act* and the *Trade Marks Act*[209].

The dual registration of security interests in IP rights is inefficient; specialist registers do not exist for every family of IP rights; and nor is there adequate publication of security interests in all types of IP rights. Registrations of assignments and security interests differ across the statutes while reliance on common law and equitable concepts such as “good faith” add to the complexity of the law. Searching for data can be cumbersome, costly and may not be fruitful. To operate effectively, financiers need to understand the legislative framework across a range of laws.

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[204] *Patents Act 1990*, section 189(1); *Trade Marks Act 1995*, section 22(1) and *Designs Act 2003*, section 12(1).
[205] In addition, the purchaser must act in good faith, for value and without notice of any fraud on the part of the owner. Refer to *Patents Act 1990*, section 189(2); *Trade Marks Act 1995*, section 22(2) and *Designs Act 2003*, section 12(1).
[206] *Patents Act 1990*, section 189(3); *Trade Marks Act 1995*, section 22(3) and *Designs Act 2003*, section 12(3).
[207] Section 262(1) (e) of the *Corporations Act 2001* (Cth).
[208] Section 266 of the *Corporations Act 2001* (Cth).
[209] Section 279(5) (d) of the *Corporations Act 2001* (Cth).

Because these arrangements are complex, IP financiers tend to structure their transactions to avoid them. The financing of IP rights has become a specialty area of legal practice. Rather than relying on financing strategies that are well established in relation to other forms of property, IP financing tends to rely on structures that are increasingly peculiar to IP, such as:

– licensing arrangements (particularly exclusive licences);
– assignment with an obligation to transfer back on satisfaction of the secured obligation (also known as legal mortgages); and
– the assignment of the IP to special purpose companies in which the parties' rights are established at the corporate level rather than in relation to the underlying IP.

Part B – Approach to Reform

A long time coming

Australian PPS reform has a long history tracing back to the late 1960's and 1970's. Early law reform reports recommended that a functional approach be taken to secured transactions in consumer and commercial contexts. The history of Australia PPS reforms is set out in Attachment A. Of particular import, the current reforms commenced in 2006, and were embraced by the Council of Australian Governments. This signalled pivotal Federal and State Government cooperation – a precondition for garnering broader support from within the financial community.

Australian PPS reform has involved significant resources across governments and industry. The Australian Government has committed $113.3 million (AUD) over five years to implement the reforms. It has been important to establish the scope of the reform, procure and implement project management services, identify key areas of risk as well as laws and registers affected by the reforms, consider new policy approaches and drafting approaches, procure IT services to build the register, consider data integrity and migration issues, develop plans for a Registry office and a call centre, and many other considerations. Much attention has been given to ensuring that industry, professional firms, associations, consumer groups and other stakeholders are kept well informed and are given every opportunity to contribute to the reform process.

The reforms are scheduled to commence on May 1, 2010. A great deal is still to be done. Legislative processes are anticipated to commence in the first half of 2009, with passage of the PPS Bill expected around October 2009. Another key aim is to have the registry implemented by the end of February 2010, in order to commence data migration from existing registers and pre-registration of existing security agreements. Banks, finance companies and brokers are eager to be ready to connect to the new IT system as soon as it becomes available for pre-registration. An IT user group has been established especially to facilitate this outcome.

The functional approach

Australian PPS reform will take a functional approach to security interest transactions. This means that the PPS Bill would apply to all "security interests" arising from transactions over personal property that, in substance, secure payment or the performance of an obligation.

Other transactions would be deemed to be security interests, regardless of whether they secure the performance or payment of an obligation, for example, certain interests arising as a result of a sale of accounts or chattel paper[210].

The PPS Bill sets out the requirements for an effective security agreement, and to ensure its enforceability against third parties. It establishes the circumstances in which a person will take personal property free of a security interest, and provides general rules for determining priority among competing security interests in the same collateral. There will be special priority rules for transactions designed for specific acquisitions and for other interests such as the sale of accounts. The PPS Bill sets out processes for enforcing a security agreement following debtor default, which may be contracted out of in certain circumstances. The PPS Bill also establishes a single national online register of security interests taken over personal property. The key object of the PPS Register is to provide a public alert system of security interests for priority purposes. Although registration will be voluntary, the use of the register for determining priority should encourage its take-up.

Finally, the PPS Bill establishes a regime for transitioning to the new scheme. The priority of existing security interests will be protected for the first 24 months of the scheme's operation. If secured parties wish to maintain their priority position after that time, they will have to opt-in to the new system. They should, in any case, consider opting into the new scheme in order to protect against the possibility of grantor insolvency.

Part C – Overview of the approach taken in advancing Australian PPS reform

Consultation

Australian PPS reform has given rise to challenges across many fronts. A key lesson learnt from the Australian experience is the importance of engaging with the stakeholders about specific issues that impact on their capacity to implement the reforms. The finance community, in particular, has been instrumental in continuing the momentum for PPS reform. Other stakeholders, such as industry bodies, professional firms, academics, consumer groups and individuals with experience in Australian and overseas PPS reform have contributed differing views about the reforms. There have been some thorny issues. Consensus, where achieved, has been well-earned.

Australian PPS reforms has strongly benefited from the specialised knowledge of experts, including in IP and finance law[211]. It is rare for experts to have detailed knowledge of both their specific industry and the finer nuances of complex commercial and financing transactions. Equally rare is knowledge of financing transactions across all industries. Reconciling the array of expert views can be a difficult task.

Some stakeholders have called for strict adherence to overseas models without close examination of alternative approaches suited to the Australian financial environment. It is well established that law reform involves a preparedness to consider new ways of dealing with old problems. While there is much to be said for relying on proven success stories, success is difficult to measure and solutions must be properly targeted to meet local

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[210] Section 28 of the PPS Bill.

[211] On-going consultation with stakeholders, especially IP Australia, will ensure that the PPS Bill will be complaint with international IP treaties to which Australia is a signatory to.

circumstances and stakeholder expectations. At the same time, criticisms of this nature have meant that departures from comparable jurisdictions are well scrutinized and developed.

Special and general register

A security interest will not attach to personal property, including IP rights, unless the grantor has an interest in the property or the power to transfer an interest in the property to another person[212]. It will be necessary for secured parties to undertake due diligence to satisfy themselves that the grantor has the requisite interest in the collateral. In the case of patent, trade marks, designs and plant breeder's rights, this would ordinarily involve a search of the relevant register held by IPAustralia.

The registers held by IPAustralia will remain the definitive source of information about title to patent, trade marks, designs and plant breeder's rights. However, the PPS Register established under the PPS Bill will be relevant to determining the priority of security interests in IP rights

The establishment of the PPS Register is therefore a major plank of the PPS reform in Australia. However, the design and build of the PPS Register have produced some challenges.

Settling the requirements for the new IT system has been a major exercise. This is due to a number of factors, including: the difficulty in translating legal requirements into IT specifications; refinements to the PPS Bill, which translate into changed and new system requirements; migration of data from disparate registers into the new national PPS Register; conducting legal risk reviews; as well as ensuring the usability of the system.

Another concern is to ensure the optimal performance of the new PPS Register, which must be available around the clock. The PPS Register will rely on interfaces with other registers, and the system will need to update quickly so that users can obtain correct and up-to-date data as at any particular time. Work is continuing towards eliminating the possibility that a single point of failure might cause the PPS Register to fail in its initial period of operation and at other milestone dates, such as the end of the transition period.

Apart from the design and system performance issues, it is imperative that data migrated into the PPS Register from other sources is complete. As with other registry owners, the Australian Attorney-General's Department is liaising with IP Australia to establish the scope of data migration and interfaces between the PPS Register and the specialist registers.

A significant proportion of the $113.3 million allocated to PPS reform over a five year period will be spent on the development and maintenance of the PPS Register. Careful project management is required in undertaking the reform in order to work within budged and meet the timelines imposed by the Council of Australian Governments. Project management is made more complex as aspects of the reform are being undertaken in tandem and are often reliant on the outcomes of other aspects of the project. Furthermore, the size of this task requires it to be broken down into discrete sub-projects with detailed plans for the progression of each through the various development stages.

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[212] Section 61(1)(a) of the PPS Bill.

Scope of the reform - validity, existence and content of IP rights unaffected

The PPS Bill will govern security interests in personal property. Each IP Act specifically provides that the rights they govern are personal property. It is proposed that the rules regarding the validity, existence and content of IP rights would continue to be governed by the relevant statute or the common law. However, in line with the objective of streamlining the law on security interests, the law on security interests over IP rights would be dealt with under the PPS Bill.

Security interests and licences

The PPS Bill extends the definition of personal property to include a licence[213]. However, IP licences are personal property only if the licence is transferable by the licensee. It does not matter whether the licence is exclusive, and whether a transfer is restricted or requires the licensor's consent.

> *Example:* Software Ltd owns the copyright to a popular software program. Licensees do not hold the right to transfer the licence to another person. The licences are not personal property, and are not affected by that PPS Bill.
>
> So far as possible, the PPS Bill seeks to apply the same rules to security interests in IP rights and other forms of personal property. Nevertheless, the PPS Bill includes rules that are particular to IP rights. These are explored in the next Part.

Part D – Accommodating IP in PPS reform

IP rights as intangible property

The PPS Bill divides all personal property into one of three categories: tangible property, intangible property and financial property. The distinction between tangible and intangible property is important because some rules relate to when a person takes physical possession of the property. These rules must be adapted to accommodate intangible property. The PPS Bill generally applies the same rules to IP rights as intangible property as it does to other forms of intangible property.

Licences not security interests

An important divergence from the functional approach is that a "licence" (including an IP licence) will not be a 'security interest' for the purposes of the PPS Bill[214]. Commonly, an IP licence may authorise the licensee to do certain acts in return for the payment of royalties on condition that the licence will terminate for a material breach, such as non-payment. To that extent, an IP licence could secure payment or the performance of an obligation. This is in stark contrast to the treatment of a lease over tangible personal property, which is the functional equivalent of a licence, and will be treated in some circumstances as a security interest under the PPS Bill.

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[213] Bare licences would not satisfy the definition of a licence under section 40 of the PPS Bill.
[214] Sections 28 (3) and 40 of the PPS Bill.

Example: WebBus Ltd operates a web site that licenses the reproduction of photographs in commercial publications. WebBus has granted a security interest to Credit Ltd over all of its present and future property securing line of credit provided by Credit to WebBus. Photograhics Ltd owns the copyright in Image 7421. Photograhics has authorised WebBus to negotiate licensing agreements for the publication of copies of Image 7421. The agreement obliges WebBus to pay Photographics the royalties received under each publication agreement for Image 7421, less money retained to cover WebBus' services. The agreement also provides for the automatic termination of WebBus' licence upon failure by WebBus to distribute royalties owning to Photographics within a specified time. Despite the licences exhibiting the functional characteristics of a security interest, the PPS Bill specifically provides that licences are not a security interest.

The exclusion of IP licences from the concept of a security interest is a departure from the functional approach, and has caused confusion amongst some stakeholders, especially in relation to partial assignments and exclusive licences. A partial assignment of an IP right would result in the partial assignee being the owner of that assigned right with statutory rights of action against persons who infringe that right[215]. Similarly, an exclusive licensee may have through legislation the same rights of action against infringers as the rights holder[216]. In either case, the relevant contract may provide for the assigned rights to return to the original rights holder, or for the revocation of the exclusive licence, upon the failure to pay for the assignment or make the royalty payments. These transactions are functionally equal, and are often used interchangeably. Partial assignments will be a security interest under the PPS Bill, but exclusive licences will not.

Example: Company A grants an exclusive licence of video rights in a copyrighted motion picture to Company B in return for royalties. The exclusive licence will not be registered on the PPS Register.

Example: Bank A lends money to Company A. Company A makes a partial assignment of a copyrighted motion picture to secure the loan. As the partial assignment constitute a security interest under the PPS Bill, the transaction will be governed by the PPS Bill.

IP as inventory

The PPS Bill recognises that inventory may comprise both tangible and intangible property[217]. IP rights held as inventory must satisfy the general test for determining whether it is inventory. Inventory therefore includes, for example, IP rights held by the grantor for sale.

The PPS Bill will define "accounts" to include IP royalties. IP royalties will therefore be subject to the rules in the PPS Bill that apply to accounts. As a result, the PPS Bill will protect the interests of those who provide new value by purchasing future royalty revenue. Thus, where an IP holder assigned its right to receive royalties, the assignment would be subject to the priority rules in the PPS Bill and would be registrable on the PPS Register.

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[215] Section 30 of the *Copyright Act*.
[216] Section 119 of the *Copyright Act*.
[217] Section 26 of the PPS Bill, definition of 'inventory'.

The PPS Bill acknowledges the injection of new value achieved by assignments of accounts by giving elevated priority to persons who purchase accounts over almost all other types of security interests where the requisite notice requirements are met. The notice requirements operate to alert other security interest holders to a change of the grantor's circumstances, including the imminence of payment for the assignment.

The provisions of the PPS Bill relating to inventory apply equally to IP held as inventory. For example, the PPS Bill will make it possible to apply to IP rights the priority rules relating to purchase money security interests (PMSI)[218] in inventory and the proceeds of inventory[219].

> *Example:* WebBus Ltd operates a web site that sells copyright to publishers. WebBus has granted a security interest to Credit Ltd over all of its present and future property securing line of credit provided by Credit to WebBus. Photograhics Ltd owns the copyright to Image 7421. Photograhics has sold WebBus 1000 licences to reproduce copies of Image 7421. WebBus paid for the licences with a single payment financed by Bank Ltd. WebBus sells the licences through its web site. The licences are held by WebBus as inventory. Bank holds a purchase money security interest in the licences, which also extends to WebBus' accounts receivables due on the sale of the licences. These largely take the form of credit card receivables. WebBus assigns to Factor Ltd its accounts receivables due on the sale of the licences. Under section 109 of the PPS Bill, Bank will have priority over Credit in relation to the receivables. Section 110 of the PPS Bill will also determine the priority of Bank relative to Factor in relation to the receivables.

Possession of IP rights: perfection, priority and enforcement

The principal means of perfecting a security interest under the PPS Bill are by registration, possession and control[220]. This is particularly important for IP rights, which may be manifested in tangible property but are not readily amenable to "possession" in the ordinary sense of the word. Physical "possession" of tangible property that exhibits an IP right (such as a book containing copyright material) would not be sufficient to alert others of possible ownership of the copyright or a security interest in that right. Given that it is not possible to take possession of an intangible, security interests in IP rights would ordinarily be perfected by registration.

A number of the rules relating to priority and enforcement of a security interest in intangibles have been modified where "possession" would otherwise be the anchor of the rule. In many circumstances, for intangible property, the anchor will be the time of attachment of the security interest. That is, where the PPS Bill would otherwise apply by reference to the grantor having taken possession of tangible property, alternative rules would be triggered by the security interest having *attached* to the IP[221].

> *Example:* Chair Ltd produces office chairs. Chair has granted a security interest to Credit Ltd over all of its present and future property securing line of credit provided by

[218] In general terms, a purchase money security interest is a security interest where the secured party has provided the finance required by the grantor to acquire the specific collateral.
[219] Sections 109 and 111 of the PPS Bill.
[220] Perfection by control is relevant only for financial property.
[221] Sections 109 (1)(b)(ii) of the PPS Bill.

Credit to Chair. Inventor Ltd owns the patent to a hydraulic system that can be used to manufacture office chairs. Inventor grants Chair an exclusive transferable licence to exploit the patent in the manufacture of office chairs in Australia. Chair pays for the licence with a single payment to Inventor. Bank Ltd lent Chair the money that enabled it to pay for the licence. The licence is not a security interest. Even without the exclusion of licences from the concept of security interests, the licence would not be a security interests, because the licence does not secure payment or performance of an obligation to Inventor. Bank has a purchase money security interest in the licence. Because the licence is held by Chair as inventory, Bank's purchase money security interest will have priority over amounts owed by Chair to Credit; provided Bank registered against Chair in relation to the licence before Bank's security interest *attached* to the licence. The security interest will attach to the licence when Chair has rights in the licence and value is given by Chair to Inventor for the licence. Had the collateral been tangible property, it would have been necessary for Bank to register before Chair took possession of the collateral.

A similar issue arises in relation to enforcement: specifically, the "seizure" of collateral following default by the debtor. When the collateral is intangible property, the secured party cannot take physical possession the collateral. The PPS Bill allows a secured party to seize intangible personal property by giving notice of the seizure to the grantor[222]. Where the collateral is a licence, the secured party must also give a notice to the licensor or the licensor's successor[223].

Transfer of higher tier interests

The PPS Bill would provide that third parties take personal property free of a security interest in circumstances where the personal property is purchased in the ordinary course of business, or in certain other circumstances. It is important to distinguish between a transfer of the licensor's rights in the IP, and a transfer of a right that the licensor has licensed. The PPS Bill includes a general principle that successors in title to the licensor are bound by a security agreement granted by the licensee in the licence, if the licensee continues to hold the licence after the transfer[224]. This principle is modelled on the notion that if the licence survives the assignments of the IP rights, the successor in title to the IP right is bound by licences granted by the transferor licensor to the same extent that the transferor was bound by those licences[225].

Example: Photographer Ltd has granted to WebBus Ltd a licence in copyright that it owns. WebBus has granted a security interest in the licence to Credit Ltd. Photographer sells the copyright to Printer Ltd. The transfer agreement provides that the licence held by WebBus continues despite the transfer to Printer. Printer will therefore be bound by the security interest in WebBus's licence to the same extent that Photographer was bound by that licence.

[222] Section 162 (2) of the PPS Bill.
[223] Section 162 (2) of the PPS Bill.
[224] Section 127 of the PPS Bill.
[225] However the PPS Bill does not affect the existing ability of licensors to revoke the licenses which they have granted. A licensor *may* be able to revoke a contractual licence even where the licence contains an express or implied term that the licence will not be revoked, through this may make the licensor liable in damages for wrongful breach of contract.

Collateral descriptions

The PPS Bill provides that a security interest in IP rights will be enforceable against a third party when the security agreement describes the personal property (among other things)[226]. Similarly, a security interest in IP rights will be perfected when the IP rights are registered[227]. A registration of IP rights must include a description of the IP rights[228].

The PPS Bill includes a provision designed to facilitate the inclusion of descriptions of IP rights in the security agreement and the collateral registration[229]. In certain circumstances, a security interest that has attached to IP rights will be taken to be included in a description of the collateral in a security agreement and in the collateral registration. Significantly, the provision applies only when a security interest has attached to IP rights. The provision does not deem the security interest to exist in the IP rights.

The provision applies when:

- the payment or obligation that is secured by the security interest in the IP rights is also secured by a security interest in tangible property;
- a registration in the PPS Register perfects the security interest in the tangible property; and
- the exercise by the secured party of rights arising under the security agreement in relation to the tangible property necessarily involves the exercise of the IP rights.

The inclusion of the description in the security agreement or collateral registration will be subject to the parties' contrary intention.

Example: Manufacturer Ltd produces car parts using a robot. The operation of the robot exploits a patent. Manufacturer is the registered owner of the patent. Credit Ltd provides finance to Manufacturer secured against the robot. The security agreement and the collateral description included in the Personal Property Securities Register refer only to the robot, and do not refer to the patent. Nevertheless, upon default by Manufacturer to Credit, the court determines that the security interest also attached to the patent. Consequently, the security agreement and the registered collateral description are taken to include the patent. As a result, the secured party meets the requirements in the PPS Bill for the enforcement of the security interest against third parties and its perfection that the security agreement and the registered description include the patent.

Example: Manufacturer Ltd produces car parts using a robot. The operation of the robot exploits a patent. Inventor Ltd is the registered owner of the patent. Manufacturer holds a licence in the patent from Inventor. The licence includes a term terminating the licence should Inventor become insolvent. Credit Ltd provides finance to Manufacturer secured against the robot. The security agreement and the collateral description included in the Personal Property Securities Register refer only to the robot, and do not refer to the patent. Upon

[226] Section 63 of the PPS Bill.
[227] Section 64 (2) (a) (ii) of the PPS Bill.
[228] Section 191, Table Item 4 of the PPS Bill.
[229] Section 38 of the PPS Bill.

default by Manufacturer, the Manufacturer's licence is terminated. Credit seizes the robot, but is unable to use the robot in a way that exploit's the patent.

Conflict of laws

Presently, the PPS Bill does not contain conflict of laws rules. Absent any conflict of law provisions, private international (common) law would resolve disputes with an international dimension.

As a broad proposition, under the functional approach to security interests, conflict rules provide that a security interest in an intangible is governed by the law of the location of the grantor.

However, this rule is inconsistent with the general approach to IP rights as a bundle of nationally determined rights applicable only in the jurisdiction where the rights are exercised.

Consideration is being given to amending the PPS Bill to provide that the law of the jurisdiction that governs the IP right or IP licence will also govern proceedings relating to the validity, perfection, and the effect of perfection or non-perfection of security interests attached to the IP rights or licence. Stakeholders have indicated broad support for this approach.

Example: Company A (a US company) is the registered owner of a patent registered on the Australian patents register. Company A obtains a loan from Bank A (a Japanese bank) secured against the patent registered on the Australian patents register. The conflict model proposed will have the effect that the PPS Bill will govern the validity, perfection and effect of perfection or non-perfection of the security interests, and will thus be required to be registered on the Australian PPS register.

Conclusion

Embarking on PPS reform requires substantial resources and complex policy choices across a range of areas from legislative reform to project management and IT design.

Stakeholder commitment to the reform is crucial, particularly from the financial community who bears the brunt of implementing reforms affecting their everyday business. The Australian Government has actively and extensively engaged with the banking and finance sectors, key law firms and other stakeholders dealing with complex financial transactions and everyday business dealings. This active engagement has helped to iron out potential issues with the legislative proposals, IT design and planning, and communications and training strategies.

Personal property financing in Australia is characterized by uncertainty, complexity, high cost and inconsistency. Australian PPS reform aims to overcome these problems by adopting a functional approach. This has presented some intricate issues for dealing with different property types, including IP rights and other intangibles. Striking the right balance has been a matter of awareness-raising, debate and compromise. As a result, there will always be criticism from some stakeholders in relation to some issues. However, by establishing consistent and certain rules for security interests, it is expected that the PPS reform will lead to an increase in the use of IP as collateral in secured transactions.

Appendix A – Timetable for Australian PPS Reform

Personal property securities law reform in Australia can be traced back to the late 1960s and early 1970's, when the Standing Committee of Attorneys-General (SCAG) and Victorian Attorney-General commissioned reviews into consumer credit transactions[230]. During the early 1990's, the Australian Law Reform Commission considered the reform in some significant detail and published a draft national PPS Bill in 1993. In response, the Australian Government published a discussion paper in 1995 proposing a single legal regime for PPS in Australia.

The private sector also did much to progress discussions regarding PPS reform. In 2002, the Banking Law Association established a committee with representatives of interested stakeholders whose work culminated in a draft PPS Bill that was discussed at a workshop held at Bond University in 2002. The proceedings and outcomes of this workshop were published in a special issue of the Bond Law Review in December 2002[231].

At a government level, PPS reform was advanced again in April 2006, when the SCAG released an options paper for public comment on the merits of national reform[232]. The paper sought comment on whether the Government should proceed with reforms adopting the functional approach and, if so, the key design features for a registration system to underpin a regime based on providing notice of security interests to third parties. The proposal for reform received strong support. A series of seminars held in mainland state capitals to explain the basis for reforms was well attended and received.

Since April 2006, the Attorney-General's Department has released three discussion papers canvassing details of the proposed reforms and seeking public feedback[233]. The purpose of these was to encourage discussion and to seek comments on the best practice and industry requirements for a streamlined and effective national regime. A Consultative Group of key representatives in the banking, finance, legal, consumer, government and academic sectors was also established in September 2006, to advise government on the reforms.

In April 2007, COAG agreed to the establishment of a national system for registration of personal property securities. This system would be funded by the Commonwealth and underpinned by Commonwealth legislation based on a reference of legislative power from the

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[230] Committee of the Adelaide Law School, 'Report to the Standing Committee of State and Commonwealth Attorneys-General on the Law Relating to Consumer Credit and Money Lending' (Rogerson report), Government Printer, Adelaide, 1969, and the Law Council of Australia, 'Report on Fair Consumer Credit Laws' to Attorney-General for the State of Victoria, Government Printer, Melbourne, 1972.

[231] Allan *et al*, 'Special Issue: Proceedings of a Workshop on Personal Property Security', (2002) 14 Bond Law Review 1.

[232] Standing Committee of Attorneys-General, 'Review of the Law on Personal Property Securities,' Options Paper, Canberra, 2006.

[233] Australia, 'Review of the Law on Personal Property Securities: Registration and Search Issues,' Discussion Paper 1, Canberra, 2006; Australia, 'Review of the Law on Personal Property Securities: Extinguishment, Priorities, Conflict of Laws, Enforcement, Insolvency', Discussion Paper 2, Canberra 2009; Australia, 'Review of the Law on Personal Property Securities: Possessory Security Interests', Discussion Paper 3, Canberra, 2007.

States. COAG also requested that an inter-government agreement between the Commonwealth, States and Territories be prepared to record agreement between jurisdictions on the scope of the reform and the ongoing management of the proposed national system. In May 2007, the Australia Government announced that it would provide $113.3 million over five years to harmonise PPS law in one Commonwealth Act and to develop a single national online PPS register.

On May 16, 2008, the Australian Attorney-General released a consultation draft PPS Bill for public comment[234]. On August 29, 2008, the Attorney-General also released a discussion paper outlining the regulations that it is proposed to be made. Consultation period followed the releases. As a result of the submissions received, a number of changes will be made to the PPS Bill and proposed Regulations. In particular, it is envisaged that a number of changes relating to the registration of interests in the various IP-registers and the effect of such registrations, will be made to the relevant IP statutes.

On November 12, 2008, the Senate referred an exposure draft of the PPS Bill to the Standing Committee on Constitutional and Legal Affairs for inquiry and report. The Senate Committee was expected to table its report in March 2009.

In addition to the work on the legislation, significant progress has also been made on the development of the national PPS Register. In October 2008, a Systems Integrator was appointed to design, build and eventually maintain the PPS Register. As part of that tender process, the Statement of Requirements for the PPS Register was made available to the public. The Statement of Requirements provides a useful starting point for businesses seeking to understand their options to interface with the PPS Register.

The design of the PPS Register will allow for the migration of data and establishing links with other registers (e.g., the National Exchange of Vehicle and Driver Information Systems, which records motor vehicle details, such as Vehicle Identification Numbers, in Australia). A contact centre will also be established to support the operation of the PPS Register. It is envisaged that the PPS Register will be available for industry testing from November 2009, the build and testing phase completed by March 2010, and be operational in May 2010.

Liaison with the States and Territories will continue regarding the State and Territories' referral and consequential amendment legislation. It is envisaged that the first State and Territory referral legislation will be introduced in April 2009, and the last State and Territory consequential amendments passed in September 2009.

The Department will continue to work with stakeholders to assist with their preparations for transition and integration into the new PPS Register before it commences operation in May 2010. Whilst the specific program has yet to be settled, it is likely to include newsletters, education seminars, and continuing consultation with stakeholders. A public communications campaign on the launch of the PPS Register will also be undertaken in January 2010.

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[234] See *http://www.ag.gov.au/www/agd/agd.nsf/Page/Consultationsreformsandreviews_personalpropertysecuritiesreform_PPSDownloads*.

Postscript: The legislative process for Australia's proposed secured transactions law (the Personal Property Securities Bill 2009) began in mid-2009, and the parliamentary process was expected to be completed during or after the 4th quarter of 2009. A copy of the proposed legislation is available at:
http://www.parliament.nsw.gov.au/prod/parlment/nswbills.nsf/0/5AEC9444216B3714CA2575D700336551

[Annex I follows]