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Security rights in intellectual property rights

Note by the Secretariat*

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* This note is submitted two weeks less than the required ten weeks prior to the start of the meeting because of an extremely heavy workload and the need to complete consultations and finalize subsequent amendments.



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G. Priority of a security right

1. The general approach of the *UNCITRAL Secured Transactions Guide*

1. Under the *UNCITRAL Secured Transactions Guide*, the priority between security rights in the same assets granted by the same grantor is based on the time of registration (i.e. before creation) or the time a security right was made effective against third parties (i.e. after creation; see recommendation 76).

2. However, a security right that was made effective against third parties by registration in a specialized registry (that provides for registration of security rights) is superior to a security right that was made effective against third parties by registration of a notice in the general security rights registry (see recommendation 77, subparagraph (a)). Similarly, with limited exceptions, transferees of encumbered assets take the assets subject to any security right that was effective against third parties at the time of the transfer (see recommendations 78-82).

2. Possible asset-specific adjustments

3. The Working Group may wish to consider whether the commentary should explain in detail the application of the relevant recommendations of the *UNCITRAL Secured Transactions Guide* to security rights in intellectual property rights, along the lines described in the following paragraphs.

(a) Identification of competing claimants

4. For a priority conflict to be subject to the *UNCITRAL Secured Transactions Guide*, it has to involve at least one secured creditor (or assignee in an assignment by way of security, which is treated as a secured transaction) that obtained a security right under the law recommended in the *UNCITRAL Secured Transactions Guide*. A transferee of an asset following enforcement of a security right upon default is an ordinary transferee taking the asset from the grantor through the secured creditor, who simply exercises the rights of the grantor under authority given by the grantor (see recommendation 79). A transferee acquiring an intellectual property right from the grantor after the creation of a security right by the grantor acquires it subject to the security right and thus to the rights of the transferee who acquired the intellectual property right from the secured creditor following enforcement because this second transferee cannot have more rights than the transferor. Where the conflict is between transferees or exclusive licensees, the matter is left to intellectual property law and the *UNCITRAL Secured Transactions Guide* does not apply.

5. If the conflict is between security rights in the same intellectual property rights granted by the same grantor under the law recommended in the *UNCITRAL Secured Transactions Guide*, the first right registered or made effective against third parties, which ever occurs first, has priority (see recommendation 76; for other priority conflicts dealt with in the *UNCITRAL Secured Transactions Guide*, see the following paragraphs), unless otherwise displaced by laws relating to intellectual property rights (see recommendation 4, subparagraph (b)).

(b) Relevance of knowledge of prior transfers or security rights

6. Under the *UNCITRAL Secured Transactions Guide*, knowledge of the existence of a security right on the part of a competing claimant is irrelevant for determining priority (see recommendation 93). As mentioned, many intellectual property laws provide that a later conflicting transfer or security right may only gain priority if it is registered first and taken without knowledge of a prior conflicting transfer. The *UNCITRAL Secured Transactions Guide* does not affect the application of that rule (see recommendation 4, subparagraph (b)).

(c) Priority of a right registered in an intellectual property rights registry

7. As already mentioned, the *UNCITRAL Secured Transactions Guide* does not apply to conflicts between transferees, unless one of the transferees took a right through an assignment of intellectual property rights by way of security under secured transactions law and there is no priority rule of intellectual property law that applies to that conflict (see recommendation 4, subparagraph (b)). The *UNCITRAL Secured Transactions Guide* does apply to priority conflicts: (i) between a secured creditor that registered a notice of its security right in the general security rights registry and a secured creditor that registered its security right in the relevant intellectual property rights registry; (ii) between two secured creditors that registered their security rights in the relevant intellectual property rights registry; (iii) between a transferee or licensee and a secured creditor; and (iv) between two secured creditors that registered their security rights in the general security rights registry.

8. The general rule is that registration in a specialized registry (including an intellectual property rights registry) provides a security with higher priority status than a security right registered in the general security rights registry (see recommendations 77 and 78). This rule is also appropriate with respect to security rights in intellectual property rights.

9. More specifically, if the conflict is between two secured creditors, one of whom registers a notice in the general security rights registry and the other registers its security right in the relevant intellectual property rights registry, the *UNCITRAL Secured Transactions Guide* applies and gives priority to the secured creditor that registered in the relevant intellectual property rights registry (see recommendation 77, subparagraph (a)). If the conflict is between security rights registered in the relevant intellectual property rights registry, as required by intellectual property law, the first right registered has priority and the *UNCITRAL Secured Transactions Guide* confirms that result (see recommendation 77, subparagraph (b)). If the priority conflict is between a transferee of intellectual property rights and a secured creditor that at the time of the transfer had registered in the relevant intellectual property rights registry, the secured creditor prevails (i.e. the transferee takes subject to the security right). However, if the secured creditor had not registered its security right in the relevant intellectual property rights registry, the transferee (who is a transferee and what are the requirements for a transfer is a matter of intellectual property law) takes the encumbered intellectual property rights free of the security right (see recommendations 78 and 79).

(d) Priority of a right that is not registrable in an intellectual property rights registry

10. If a priority conflict is between a security right registered or otherwise made effective against third parties under the law recommended in the *UNCITRAL Secured Transactions Guide* and a security right in an intellectual property right with respect to which there is no intellectual property rights registry, priority for security rights is determined by the order of registration in the general security rights registry or third-party effectiveness (see recommendation 77). If there is a contrary intellectual property law priority rule, it prevails (see recommendation 4, subparagraph (b)). A subsequent transferee or licensee would, in principle, take the asset subject to the security right (see recommendation 79). If the asset had been transferred by the grantor of the security right before the creation of the security right, the secured creditor will have no security right at all on the basis of the first in time rule (based on the generally acceptable *nemo dat* property law rule, the application of which the *UNCITRAL Secured Transactions Guide* does not affect).

(e) Rights of transferees of encumbered intellectual property rights

11. The *UNCITRAL Secured Transactions Guide* addresses sufficiently the situation where the security right is created and made effective against third parties and thereafter title to the intellectual property right is transferred. The basic rule would be that the transferee takes the intellectual property right subject to the security right (see recommendation 79). The secured creditor in effect takes the asset with a right to sell it free of the rights of the transferee if the grantor defaults and the secured creditor enforces its security right. So, the transferee acquiring the intellectual property right from the secured creditor is in effect a prior transferee who took the asset from the grantor through the secured creditor compared with the transferee who took the asset directly from the grantor after the security right became effective against third parties.

12. There are two exceptions to this rule. The first exception arises where the secured creditor authorizes the disposition or license free of the security right (see recommendation 80). The second exception relates to a non-exclusive licence in the ordinary course of the licensor's business (see recommendation 81, subparagraph (c)).

(f) Rights of licensees in general

13. Intellectual property rights are routinely licensed. The retained rights of a licensor, such as the ownership right or the right to receive royalties, and the rights of a licensee can both be used as an encumbered asset for credit. In each case, it is necessary to consider the relevant rules where the competing claimants are the lenders of the licensor and the licensee, or the licensor and the lenders of the licensee.

14. Where the holder of intellectual property rights creates and makes effective against third parties a security right and then grants a licence, in principle, the licensee takes subject to the security right created by the licensor (see recommendation 79). This means that, if the licensor defaulted on the loan and the lender sought to enforce its security right in the royalties owed by the licensee to the licensor, the lender could collect the royalties from the licensee (see also recommendation 168), as licence royalties are treated as any other receivable.

Similarly, the licensee would need to know that, so long as it continued performance of the licence agreement, its licence would not be terminated. This is matter of the licence agreement and the applicable law.

15. If the licensee also creates a security right, that security right would be subordinate to the security right created by the licensor, as the licensee took its rights subject to that security right (see recommendation 79) and the licensee cannot give to its secured creditor more rights than the licensee has (based on the *nemo dat* principle). So, if the lender to the licensor enforced its security right, it could dispose of the intellectual property rights free of the licence. Thus, the licence would terminate and the licensee's lender would no longer have an asset encumbered by its security right. The rights of the licensor and the licensee under the licence agreement and the relevant intellectual property law would remain unaffected by secured transactions law. So, if the licensee defaults on the licence agreement, the licensor can terminate it and the licensee's secured creditor would be again left without security. Similarly, secured transactions law would not apply to an agreement between the licensor and the licensee prohibiting the licensee from granting sub-licences or assigning its claims to royalties owed by sub-licensors to the licensee.

(g) Rights of ordinary-course-of-business licensees

16. One question of particular importance is whether a non-exclusive licensee "in the ordinary course of business" of the licensor should be affected by any security rights created by the licensor, if it had no knowledge that the licence violated the security right (see recommendation 78, subparagraph (c)).

17. An owner of a motion picture (a producer, for example) may grant a security right in an ownership right. The owner may then enter into an exclusive licence agreement with a distributor of the film. The distributor too may grant a security right in its rights as a licensee. The distributor may then enter into non-exclusive licence agreement with exhibitors. Alternatively, the owner may enter into non-exclusive licence agreements with distributors or directly with exhibitors or end-users. Under intellectual property law, a sub-licence depends for its existence on its licence. If the licence is terminated, any sub-licence derived from the licence also terminates, unless authorized by the original licensor either directly or in the original licence agreement. This happens because infringement does not depend on knowledge. A lack of knowledge can reduce infringement damages, but not liability.

18. Under recommendation 81, subparagraph (c), a non-exclusive ordinary-course-of-business licensee would not be affected by a security right created by the licensor, provided that the licensee does not have knowledge that the licence authorized by the licensor violates the rights of a secured creditor (i.e. an agreement between the licensor and its creditor). This does not mean that the licensee is no longer bound by the terms of the licence, including a provision that prohibits the licensee from entering into non-exclusive sub-licences. The phrase "takes free" does not mean that the non-exclusive licensee gets a "free" licence. The non-exclusive licensee may continue to use the licence following the secured creditor's foreclosure against the licensor only if the non-exclusive licensee complies with all of the terms of the licence (including payment of licence fees to the person that acquired the licensor's interest at the sale in the context of enforcement of the security right).

Thus, all of the licensee's obligations remain in place and the licensor's successor may terminate the licence agreement for non-performance by the licensee.

19. In the example given above, an exhibitor holds a non-exclusive sub-licence granted by a distributor that holds an exclusive licence granted from a producer. If the distributor's secured creditor enforces its security right, the exhibitor as a non-exclusive licensee would continue to enjoy its rights under the licence (assuming it performs its obligations). If the producer's (owner's or licensor's) secured creditor enforces its security right, however, the distributor holding a subsequent-in-time exclusive licence would lose its rights. The rights of the exhibitor, as a non-exclusive sub-licensee, would also fall because, under recommendation 82 and general law, a sub-licensee cannot have more rights than its licensee.

20. This approach seeks to balance the ability of the secured creditor to have recourse to the encumbered assets and the ability of an ordinary-course-of business licensee of the assets to retain the licensee's rights without interference from the secured creditor of the licensor.

21. For example, it indicates that a prudent secured creditor should "police" its own borrower against the borrower entering into non-exclusive licences. However, it does not require the secured creditor to "police" its borrower's licensees against entering into non-exclusive sub-licences because that would place too great a burden on the secured creditor. At the same time, it protects the reasonable expectations of non-exclusive licensees (generally non-negotiated transactions) that their rights are not subject to termination as a consequence of the licensor's default. The *UNCITRAL Secured Transactions Guide* provides a statutory rule that implements what the secured creditor and the licensor undoubtedly expect (the secured creditor will routinely authorize the licensor to enter into ordinary-course-of-business transactions). That, after all, is the business the licensor runs. However, even that expectation interest is outweighed by the burden that would be imposed on the original licensor's secured creditor if it had to "police" the sub-licensing activities of all exclusive licensee's. Finally, the rules adopt a policy that it is not asking too much for an exclusive licensee (who is more likely to be negotiating its deal) either to make a deal with the licensor's secured creditor to protect the exclusive licensee or to take its licence subject to the security right granted by the licensor.

22. If the secured creditor of the licensor does not want to encourage non-exclusive licences, it can, in its security agreement (or elsewhere), require the borrower (the licensor) to place in all of the non-exclusive licences a provision that, if the borrower grants a non-exclusive licence, it will terminate if the licensor's secured creditor enforces its security right. Similarly, if the licensor does not want its licensee to grant any sub-licences, it can include in the licence agreement a provision that the grant of such a sub-licence by the licensee is an event of default that would entitle the licensor to terminate the licence. Nothing in the *UNCITRAL Secured Transactions Guide* would interfere with the enforcement of such provisions as between the secured creditor and its borrower (or as between the licensor and its licensee). Ordinarily, of course, the secured creditor will have no interest in doing that, since the licensor (and its licensees) is in the business of granting non-exclusive licences and the secured creditor expects the borrower to use the fees paid under those licences to pay the secured obligation.

23. The exception in recommendation 81, subparagraph (c), will apply only if: (i) the secured creditor does not authorize its borrower to grant a licence (in this case recommendation 80, subparagraph (b), will apply); and (ii) the secured creditor does not prohibit the borrower from granting a non-exclusive licence (if the secured creditor does that, the licence will terminate in the case of enforcement by the secured creditor); and (iii) the licensor grants a non-exclusive licence to the licensee, in no case an unauthorized licensee would take the encumbered intellectual property right free of the security right of the licensor's secured creditor (but the contractual arrangement between the secured creditor and the licensor, which neither authorizes the owner-licensor nor prohibits the owner/licensor from granting a licence, does not produce third-party effects).

24. Somewhat comparable results may be obtained under intellectual property law. It is often the case that the secured creditor authorizes the licensor in the security agreement to grant licences. If the security agreement between the licensor and its secured creditor is silent on the point, but, as a matter of intellectual property law, the licensor, and not the secured creditor, remains the holder of the encumbered intellectual property rights, then the rights holder is typically authorized to grant licences as well. As this is common practice, in most cases licences will be authorized. Then, under typically intellectual property law priority rules, a secured creditor takes subject to these authorized licences. However, in some cases the secured creditor reserves the right to approve licences, in effect becoming a right holder in intellectual property law terms. In such a case, if the owner in breach of this provision grants a licence (or a sub-licence), then the licence is unauthorized and infringing.

25. The Working Group may wish to consider appropriate clarifications of the text of recommendation 81, subparagraph (c), as it applies to intellectual property rights and explanatory commentary to ensure that it is not inconsistent with intellectual property law (and in particular does not permit infringing licensees to take free of their licensor's security right). In any case, it should be noted that, to the extent this provision might be inconsistent with intellectual property law, it would simply not apply under recommendation 4, subparagraph (b).

H. Rights and obligations of the parties to a security agreement

1. The general approach of the *UNCITRAL Secured Transactions Guide*

26. With few exceptions, the *UNCITRAL Secured Transactions Guide* generally recognizes the freedom of the parties to the security agreement to tailor their agreement so as to meet their practical needs (see recommendation 10). At the same time, in order to enhance efficiency and reduce transaction costs, the *UNCITRAL Secured Transactions Guide* includes a few mandatory and non-mandatory rules.

27. Generally, the *UNCITRAL Secured Transactions Guide* makes reference to the agreement of the parties, as well as to any usages they have agreed to or practices they have established between them. In addition, the party in possession of the encumbered assets must take reasonable steps to preserve the asset and its value, and the secured creditor must return the encumbered asset if the security right has been extinguished by full payment or otherwise and all commitments to extend credit have been terminated (see recommendations 111 and 112). Moreover, unless

otherwise, the secured creditor may be reimbursed for reasonable expenses incurred for the preservation of the encumbered assets, make reasonable use of the assets and inspect them if they are in the possession of the grantor (see recommendation 113).

2. Possible asset-specific adjustments

(a) Application of the principle of party autonomy

28. The Working Group may wish to confirm that the principle of party autonomy applies equally to security rights in intellectual property rights and discuss any special limitations that might be necessary.

(b) Obligation of the secured creditor to pursue infringers or renew registrations

29. The Working Group may also wish to consider whether the obligation of the secured creditor to preserve the encumbered asset and its value should be extended to intellectual property rights. In this connection, one question that the Working Group may wish to discuss is whether the secured creditor should have the right or be obliged to take any action necessary to protect the intellectual property right or renew a registration. The Working Group may wish to consider that the question of who may pursue infringers or renew registrations is a matter of intellectual property law and that the parties may reach an agreement in that regard only if permitted by intellectual property law.

(c) Right of the secured creditor to pursue infringers or renew registrations

30. In addition, the Working Group may wish to consider whether, as a matter of secured transactions law, the secured creditor should have a right (not an obligation) to pursue infringers and renew registrations, if the holder of these rights fails to exercise them in a timely fashion. This approach may be justified by the legitimate interest of the secured creditor in preserving the encumbered intellectual property right and its value. The matter may be left to a default rule applicable in the absence of a contrary agreement of the parties or be left to the security agreement.

I. Rights and obligations of third-party obligors

1. The general approach of the *UNCITRAL Secured Transactions Guide*

31. The *UNCITRAL Secured Transactions Guide* discusses the rights and obligations of debtors other than the debtor granting a security right in an asset to secure the payment or other performance of an obligation. Such third-party debtors (obligors is the term used in the *UNCITRAL Secured Transactions Guide* to distinguish from the debtor-grantor) include the debtor of an assigned receivable, the person obligated under a negotiable instrument, the guarantor/issuer, confirmer, or nominated person under an independent undertaking, the depositary bank where the encumbered asset is the right to payment of funds credited to a bank account and the issuer of a negotiable document.

2. Possible asset-specific adjustments

32. Where the encumbered asset is the right to claim royalties under a licence agreement, the third-party obligor's rights and obligations would be the same as the

rights and obligations of the debtor of a receivable. Where the encumbered assets are the rights of a licensee under a licence agreement, the licensor is not a third-party obligor in the sense of the *UNCITRAL Secured Transactions Guide*. The rights and obligations of the licensor are a matter of intellectual property law and, in any case, law other than secured transactions law. The Working Group may wish to consider whether appropriate explanations should be included in the commentary.

J. Enforcement of a security right

1. The general approach of the *UNCITRAL Secured Transactions Guide*

33. Under the *UNCITRAL Secured Transactions Guide*, after default the secured creditor is entitled (see recommendation 141):

- (a) To obtain possession of a tangible encumbered asset;
- (b) To sell or otherwise dispose of, lease or license an encumbered asset;
- (c) To propose to the grantor that the secured creditor accept an encumbered asset in total or partial satisfaction of the secured obligation;
- (d) To collect on or otherwise enforce a security right in an encumbered asset that is a receivable, negotiable instrument, right to payment of funds credited to a bank account or right to receive the proceeds under an independent undertaking;
- (e) To enforce rights under a negotiable document;
- (f) To enforce its security right in an attachment to immovable property; and
- (g) To exercise any other right provided in the security agreement (except to the extent inconsistent with the provisions of this law) or any other law.

34. In exercising its rights, the secured creditor has to act in good faith and in a commercially reasonable manner (see recommendation 131). In particular with respect to extrajudicial enforcement, the secured creditor must abide by this standard of conduct and exercise its remedies subject to certain notifications and additional safeguards (see recommendations 147-151).

2. Possible asset-specific adjustments

(a) Deferral to intellectual property law

35. In general, the exercise of remedies under secured transactions law would need to be consistent with the relevant intellectual property law. Also, the exercise of remedies under other law (such as the cancellation of a transfer or licence agreement) should not be affected. In addition, what is commercially reasonable where the encumbered asset is an intellectual property right may depend on intellectual property law and practice. The Working Group may wish to consider whether recommendation 4, subparagraph (b), may be sufficient to bring about this result, accompanied by appropriate commentary.

(b) Taking “possession” of an encumbered intellectual property right

36. The right of the secured creditor to take possession of the encumbered asset is not relevant if the encumbered asset is an intellectual property right (see recommendations 146 and 147). However, the secured creditor should be entitled to take possession of any documents necessary for the enforcement of its security right. The secured creditor should also be entitled to take possession of any tangible assets in which the intellectual property right is included, subject to rights of other parties with respect to the tangible assets.

(c) Disposition of an encumbered intellectual property right

37. The secured creditor should have the right upon the grantor’s default to dispose of or grant a licence with respect to the encumbered intellectual property right, but always within the limits of the rights of the grantor. As a result, if the grantor is the owner, the secured creditor should, in principle, have the right to assign or license the encumbered intellectual property right. However, if the grantor, before granting the security right, granted an exclusive licence which has priority over the security right, upon default, the secured creditor will not have the right to grant another licence as the grantor did not have that right and the secured creditor cannot have more rights than the grantor.

38. If the grantor is a licensee, upon the grantor’s default the secured creditor should have the right to transfer the licence (if the licence is transferable) or grant a licence (if, under the terms of the licence agreement, the grantor-licensee had the right to grant sub-licences) consistent with the terms of the licence given by the owner to the licensee.

(d) Proposal by the grantor to acquire an encumbered intellectual property right

39. The secured creditor should have the right to propose to the grantor to acquire the grantor’s rights in satisfaction of the secured obligation. If the grantor is the owner, the secured creditor could become the owner (provided that the grantor and its creditors do not object; see recommendations 156-159). Once a secured creditor becomes an owner, its rights and obligations are regulated by the relevant intellectual property law. As already mentioned (see para. 11 above), the transferee, who acquired from the grantor through the secured creditor upon default by the grantor, could prevail over a transferee who took the encumbered intellectual property right directly from the grantor after a security right has been granted in it (as the latter secured creditor cannot have more rights than the grantor).

(e) Collection of royalties

40. Where the encumbered asset is the right to receive payment of royalties under a licence, the secured creditor should be entitled to collect the royalties (see recommendation 168). In all these situations, the rights of the licensor under intellectual property law will be respected, as the *UNCITRAL Secured Transactions Guide* defers to intellectual property law (see recommendation 4, subparagraph (b)).

(f) Enforcement of security rights in tangible assets related to intellectual property rights

41. Where the encumbered assets consist of tangible assets, with respect to which intellectual property rights are used, the secured creditor should be able to dispose of them without the consent of the owner-licensor if the relevant intellectual property right has been exhausted, or if there is an authorization from the intellectual property rights holder for the secured creditor to dispose of the assets in the case of default. Of course, disposition can only occur to the extent of the exhausted rights or the authorization. Otherwise, the secured creditor would need to obtain the consent of the owner-licensor in line with the licence agreement and the relevant intellectual property law.

(g) Rights acquired through disposition

42. Rights in intellectual property rights acquired through judicial disposition would be regulated by the relevant law applicable to the enforcement of court judgements. In the case of an extra-judicial disposition in line with the provisions of the secured transactions law, a transferee or licensee would take the intellectual property right free of the security right of the enforcing secured creditor and any lower-ranking security rights, but subject to any higher-ranking security rights. The same rule applies to an extrajudicial disposition that is inconsistent with the provisions of the secured transactions law, provided that the transferee or licensee acted in good faith (see recommendations 161-163).

43. One question that would need to be addressed is whether the transferee or licensee would obtain the intellectual property right as it existed at the time the security right became effective against third parties or with any subsequent enhancements (e.g. an improvement to a patent). Generally, intellectual property laws treat such improvements as separate rights that need to be separately granted. As such, this may be a matter left to the security agreement.

(h) Enforcement of a security right in a licensee's rights

44. All those issues would need to be addressed also for situations where the encumbered asset is not an intellectual property right but the rights of a licensee arising from a licence to use intellectual property. In such a situation, the rights of the secured creditor may be constrained, as, where the encumbered asset is merely a licence, the secured creditor only succeeds to the licensee's rights. A mere licensee cannot enforce the intellectual property right against another mere licensee or secured creditor with a lower-ranking security right. Only the licensor (or appropriate right-holder) can do that (in some jurisdictions, exclusive licensees may join the licensor as a party to the proceedings). Thus, a secured creditor enforcing its security right against a licensee may have limited rights against other parties. Another issue is whether a transferee of the intellectual property rights has a right of access to information such as a source code of software held by the secured creditor for the case of default of the licensee of software.

K. Acquisition financing

1. The general approach of the *UNCITRAL Secured Transactions Guide*

45. The *UNCITRAL Secured Transactions Guide* discusses acquisition financing with respect to tangible assets. It provides for a unitary approach to acquisition financing, in the context of which all rights securing the payment of the purchase price for tangible assets fall under a unitary notion of a security right with the result that, with the exception of certain special provisions for acquisition security rights, the provisions applicable to security rights apply to acquisition security rights (see recommendations 178-186). As an alternative, the *UNCITRAL Secured Transactions Guide* provides for a non-unitary approach to acquisition financing, in the context of which the terminology of various types of rights securing the purchase price of tangible assets is maintained, while certain special provisions are introduced to ensure that retention-of-title and financial lease rights are treated as functional equivalents of acquisition security rights (see recommendations 187-202). The main provision is a priority provision giving priority to an acquisition secured creditor, a retention-of-title seller or financial lessor as of the time of the delivery of the goods to the grantor as long as the acquisition financier registered a notice in the security rights registry (see recommendations 180 and 199). This special priority extends to proceeds of equipment but not to proceeds of inventory in the form of cash proceeds (see recommendations 185 and 192). In the context of both the unitary and the non-unitary approach, there is an alternative rule, under which no distinction is made between equipment and inventory but no special priority is recognized in proceeds.

2. Possible asset-specific adjustments

46. The provisions of the *UNCITRAL Secured Transactions Guide* with respect to acquisition financing apply only to tangible assets. The Working Group may wish to consider whether there should be an acquisition security right with respect to intellectual property rights, which could have the special priority provided in recommendation 180 (and 192 for the non-unitary approach).

47. The first question may be whether intellectual property rights used in connection with a tangible asset should be subject to an acquisition security right with special priority with the consent of the intellectual property rights holder and appropriate description of the encumbered asset in the security agreement. At least where the tangible asset may not be effectively disposed of without reference to the intellectual property right (e.g. patented pumps or copyrighted books), it seems that such an acquisition security right should be possible. Otherwise, the acquisition security right in the tangible asset would be of little value.

48. The next question is whether an acquisition security right should be introduced for intellectual property rights themselves so as to ensure that a licensor could obtain priority over a secured creditor of the licensee with a security right in the intellectual property right or the royalties owed to the licensee from sub-licensees.

49. Under the *UNCITRAL Secured Transactions Guide*, a security right takes its priority from the time of registration or third-party effectiveness. If a potential licensee grants a security right in all existing and future intellectual property rights and then enters into an agreement with a licensor, the licensor cannot gain priority

over the licensee's pre-existing secured lender. The view is expressed that it seems strange that a supplier of used equipment can do so, but the licensor of the latest patent to make new replacement equipment cannot.

50. However, unlike retention-of-title sales that were developed in practice in response to practical needs, no such practice has developed with respect to licences of intellectual property. In addition, licensors may be protected in different ways. For example, a licensor may include in the licence agreement that the licensee will not create a security right in its rights under the licence. If the licensee grants a security right in violation of the agreement, the licensor can always terminate the licence agreement. Furthermore, a licensor may include in the licence agreement that, if the licensee grants a security right in its rights under the licence agreement, the licensee will ensure that the secured creditor will conclude a subordination agreement in favour of the licensor. Nothing in the *UNCITRAL Secured Transactions Guide* affects such arrangements. The licensor could also make "lock-box arrangements" (part of the royalties owed to the licensee from sub-licensees would be paid in a separate account in the name of the licensor) or even obtain a security right in the royalties owed to the licensee to secure payment of the royalties owed to the licensor. However, such arrangements would be subject to the normal priority rules.

L. Law applicable to a security right

1. The general approach of the *UNCITRAL Secured Transactions Guide*

51. Under the *UNCITRAL Secured Transactions Guide*, the law applicable to the creation, third-party effectiveness, priority and enforcement of a security right in intangible assets is the law of the State in which the grantor is located (see recommendation 208). The grantor is located in the State in which it has its place of business; in the case of places of business in more than one State, reference is made to the State in which the grantor has its central administration; and in the absence of a place of business, reference is made to the State in which the grantor has its habitual residence (see recommendation 219).

52. The mutual rights and obligations of the grantor and the secured creditor with respect to the security right are governed by the law chosen by them and, in the absence of a choice of law, by the law governing the security agreement (see recommendation 216).

2. Possible asset-specific adjustments

(a) Law applicable to proprietary matters

53. Intellectual property law conventions adopt the principle of territoriality. As a result, the law applicable to property law issues concerning intellectual property rights (title transfers, secured transactions and licence agreements) is the law of the place where the intellectual property right is protected (*lex protectionis*). Typically, a transferee or a licensee will ensure that it obtained an effective transfer or licence in the States in which the intellectual property right is protected. Similarly, a secured creditor will inquire from the owner, transferee or licensee in which States

an intellectual property right is protected and follow the rules of those States to obtain a security right, make it effective against third parties or enforce it.

54. In addition, under the principle of minimum rights, all States parties to those conventions accord a basic level of protection to intellectual property rights holders and their successors. Finally, under the principle of national treatment, each State has to treat nationals of another State no less favourably than it treats its own nationals. This creates a system in which nationals of any State know that in any other State they will be accorded at least certain minimum rights, along with any greater rights that are accorded to domestic parties. The benefits of this structure, including ease of administration and fairness in application, have been proven by experience.

55. Other possible approaches are based on the principle of “material reciprocity” or “country of origin”, in which the rights of a person in the home or “origin” State determines the extent of a person’s rights in another State.

56. A variation of the approach based on the *lex protectionis* and approach of the *UNCITRAL Secured Transactions Guide* could be to provide that, in principle, the law applicable to the creation, third-party effectiveness and priority of a security right in an intellectual property right would be the law of the grantor’s location. However, if a competing claimant obtained a superior right under the *lex protectionis*, the *lex protectionis* would apply. Another possible variation may be to limit the application of the *lex protectionis* to security rights in intellectual property rights that can be created by registration in the relevant intellectual property rights registry.

(b) Law applicable to contractual matters

57. The mutual rights and obligations of the grantor and the secured creditor with respect to the security right may be left to party autonomy. In the absence of a choice of law by the parties, the law applicable to these matters might be the law governing the security agreement (see recommendation 216). The commentary might usefully explain the application of the principle of party autonomy as to the law applicable to the mutual rights and obligations of the grantor and the secured creditor where the encumbered asset is an intellectual property right.

M. The impact of insolvency on a security right

1. The general approach of the *UNCITRAL Secured Transactions Guide*

58. The *UNCITRAL Secured Transactions Guide* addresses in Chapter XII the impact of insolvency on a security right granted by the insolvent debtor in a way that is consistent with the *UNCITRAL Insolvency Guide*. At the same time, Chapter XII includes additional insolvency recommendations to address specific secured transactions issues. It should be noted that Chapter XII is the product of the joint work of the Working Group and Working Group V (Insolvency Law).

59. Under Chapter XII, the effectiveness of a security right is preserved subject to any avoidance actions and stays (see recommendations (35), (39) and (46) of the

UNCITRAL Legislative Guide on Insolvency Law,¹ hereinafter referred to as the “*UNCITRAL Insolvency Guide*”). The third-party effectiveness and priority of a security right is also preserved subject to any preferential claims (see recommendations 238 and 239). Security rights securing post-commencement finance do not take priority over pre-commencement security rights, but the insolvency court may authorize the post-commencement creation of security rights with priority over pre-commencement security rights in certain situations (see recommendations (66) and (67) of the *UNCITRAL Insolvency Guide*). Secured creditors may be entitled to participate in insolvency proceedings if certain conditions are met (e.g. the reorganization plan affects their security rights; see recommendation (126) of the *UNCITRAL Insolvency Guide*). Similarly, secured creditors may have a right to vote on a reorganization plan, which affects their rights, and a plan may be binding on secured creditors even without their approval if certain conditions are met (see recommendations (126), (151) and (152) of the *UNCITRAL Insolvency Guide*).

60. With respect to the treatment of contracts under which both the debtor and its counterparty have not fully performed their respective obligations, Chapter XII generally provides that the insolvency representative may decide to continue the performance of a contract if continuation of the contract is beneficial to the estate or reject the contract (see recommendations (72) and (73)). With respect to automatic termination or acceleration clauses (also called “*ipso facto*” clauses), Chapter XII provides that, upon the application for commencement, commencement or appointment of an insolvency representative, such clauses are unenforceable against the insolvency representative and the debtor (see recommendation (70) of the *UNCITRAL Insolvency Guide*).

2. Possible asset-specific adjustments

61. It would seem that the following principles would be consistent with Chapter XII: (i) the insolvency representative does not have more rights than the insolvent debtor, whether that debtor is the owner, the licensor or licensee of intellectual property; (ii) what are the specific rights of the insolvent licensor or licensee under a licence is a matter of intellectual property law, but those rights might be affected by insolvency law; and (iii) the rights of their secured creditors are subject to secured transactions and intellectual property law, but may be affected by insolvency law. Under recommendation 4, subparagraph (b), in the case of inconsistencies between secured transactions and intellectual property law, intellectual property law prevails. The relationship between intellectual property law and insolvency law is, of course, not addressed in the *UNCITRAL Secured Transactions Guide*.

62. When the encumbered asset is the licensor’s right with respect to licensed intellectual property or a licensee’s right with respect to such property, analysis of the effect of insolvency on the security right can be complicated because the insolvent debtor may or may not be the grantor of the security right. For example, in the case of an encumbered asset consisting of the licensor’s rights, the effect of insolvency may differ depending on whether it is the licensor (who is also the grantor) or the licensee that has become insolvent. Similarly, in the case of an

¹ United Nations publication, Sales No. E.05.V.10.

encumbered asset consisting of the licensee's rights, the effect of insolvency on the security right may differ depending on whether it is the licensee (who is also the grantor) or the licensor that has become insolvent.

63. In each case, when it is the grantor that is the insolvent debtor, the starting point for the analysis is Chapter XII. In light of the nature of transactions in which intellectual property rights are encumbered assets, the Working Group may wish to consider whether the recommendations in Chapter XII should be augmented by additional commentary or illustrations relating to intellectual property transactions. In view of the fact that Chapter XII contains some additional recommendations that address specific secured transactions issues, the Working Group may wish to consider whether the recommendations in Chapter XII should be augmented, in a manner consistent with the principles of both Guides, to address specific issues related to security rights in intellectual property rights.

64. If the Working Group decides that additional recommendations or commentary would be necessary or useful to address these issues, as this effort will touch upon insolvency law issues addressed in the *UNCITRAL Insolvency Guide*, the Working Group will have to raise these issues with the Commission so that the Commission can make a decision as to whether the work involves issues of secured transactions, intellectual property and insolvency law and would thus require coordination between the Working Group and Working Group V (Insolvency Law) and, if so, decide on the terms of reference of such coordination.

(a) The treatment of security rights granted by a licensee in the case of the insolvency of the licensor

65. As already mentioned (see para. 60 above), under Chapter XII, the insolvency representative may decide to continue the licence agreement, performing it, or rejecting it. To the extent the decision of the insolvency representative is beneficial to the estate, secured creditors with a security right in the licensor's rights will share in the benefits, while secured creditors of the licensee may be negatively affected. Outside insolvency, these secured creditors know that, if the licensee does not perform its obligations under the licence agreement, the licence agreement could be terminated, but they can address this risk, at least to some extent, by monitoring the performance of the licensee's obligations. In the case of the licensor's insolvency though, the right of the licensee's secured creditors could evaporate without the secured creditor's fault. This is a risk that any secured creditor will have to take into account in its decision whether to extend credit and at what cost.

66. The question arises though what happens to a licensee (and its secured creditors), who borrowed and invested considerable sums in marketing or further developing the intellectual property rights (granting a security right in the intellectual property rights), or to a licensee (and its secured creditors) that is down in the chain of licences or a licensee (and its secured creditors), who borrowed and developed the intellectual property rights further (cross-licensing arrangements) and licensed it back to the licensor. To protect themselves (and preserve their ability to raise credit on their rights as licensees), licensees often negotiate for: (i) long licence terms; (ii) "non-termination" rights, i.e., a waiver by the licensor of a contractual right to terminate the license for a default (to the extent allowed by relevant law), meaning that the licensor can only recover damages but the licensee can retain the rights; and (iii) a "protective security right". Under a "protective

security right” a licensee takes a security right in the intellectual property right granted under the licence in order to secure its right to recoup any advance royalty payments and expenses, as well as potential damages in case of termination (these “protective security rights” are typical in particular in the movie business). The Working Group may wish to consider whether, in such a case, Chapter XII would apply to the rights of a licensee as if it were a secured creditor.

67. A way in which some insolvency laws deal with this issue is by allowing the licensee to elect to continue using the intellectual property under the licence even if the insolvency representative tries to terminate. The licensee must comply with all licence terms. However, the licensor’s estate is relieved from ongoing obligations, such as providing improvements. This has the effect of balancing the interests of the licensor to escape a burdensome contract and the interest of the licensee to protect its investment in the licence. The question arises as to whether this approach would be consistent with Chapter XII.

68. The application of the principles of Chapter XII to security rights in intellectual property rights may need to be discussed, in particular in the case of cross-licensing arrangements and in cases where the insolvent debtor is a licensor high up in the chain of licences and its insolvency will affect licensees and their secured creditors in several tiers.

69. Another example of an issue that may be usefully discussed is the following. As already mentioned, under Chapter XII, the insolvency representative may terminate an agreement only if it is not fully performed both by the insolvent debtor and its counterparty (see recommendation (70) of the *UNCITRAL Insolvency Guide*). The question arises in this regard whether this means, for example, that, if the licensor writes a novel for a publisher, has performed all writing services, and is only collecting royalties, the licence of the copyright in the novel to the publisher is not terminable in case of the novelist’s insolvency.

(b) The treatment of security rights granted by the licensor in the case of the insolvency of the licensee

70. If continuation of the licence is advantageous for the estate given all the circumstances of the case, the insolvency representative will likely wish to continue exploiting the intellectual property. From the licensor’s point of view (and from the point of view of the licensor’s secured creditors), there is often a strong desire to recover the intellectual property right in the belief that an insolvent licensee will not be able to devote the same resources to marketing the intellectual property right as a solvent company. There is also a concern that royalty payments might not be made as regularly as if the licensee were solvent. The following issues may need to be discussed.

71. First, it is common to include a clause in a license agreement that it automatically terminates upon insolvency of either party. These automatic termination or acceleration clauses are not enforceable in Chapter XII (see recommendation (70) of the *UNCITRAL Insolvency Guide*). Second, in many cases, at the time of the licensee’s insolvency there will be unpaid, past-due royalties. Under chapter XII, where the insolvent debtor is in breach, the insolvency representative can continue the performance of the contract, provided that the breach is cured, the non-breaching counter-party is returned to the economic

position it was before the breach and the estate can perform under the continued contract (see recommendation (79) of the *UNCITRAL Insolvency Guide*). The application of the principles of Chapter XII in these cases may be usefully explained with examples in an augmented commentary to Chapter XII.

72. Third, if the insolvency representative elects to continue to use the intellectual property, the rights holder wants to ensure that: (i) licence terms are honoured; and (ii) royalties are paid. As already mentioned, Chapter XII sufficiently addresses these issues (see recommendations (70) to (82) of the *UNCITRAL Insolvency Guide*). However, if the licensee has granted before the commencement of insolvency an effective security right in its right under the licence agreement and the insolvency representative elects to continue the licence agreement, the question arises as to whom the estate should pay future royalties, to the licensor in preference to the secured creditor or to the secured creditor since it has a security right, whereas the licensor does not. The latter result would negatively affect the rights of licensors and their ability to raise credit offering their rights as collateral, since, in effect, they would lose both the intellectual property right and the royalties.

V. Conclusions

73. The Working Group may wish to confirm that, while the *UNCITRAL Secured Transactions Guide* works well with respect to some issues arising in the context of security rights in intellectual property rights, it requires some adjustments with respect to other issues.

74. These adjustments may take the form of commentary as to the specific application of principles of the *UNCITRAL Secured Transactions Guide* to security rights in intellectual property rights. For example, commentary may include some additional definitions and explain how other definitions of terms would apply to security rights in intellectual property rights (see A/CN.9/WG.VI/WP.33, paras. 42-60). Similarly, commentary may be sufficient to explain the application of the principle of party autonomy in the case of a security agreement relating to an intellectual property right (see A/CN.9/WG.VI/WP.33, para. 108, as well as paras. 28-30 above) or to clarify some fundamental policies with respect to security rights in intellectual property rights (see A/CN.9/WG.VI/WP.33, paras. 62-75). Furthermore, commentary may be sufficient to explain how the principles of the *UNCITRAL Secured Transactions Guide* with respect to statutory and contractual limitations to the transferability of assets would apply in the case of security rights in intellectual property rights (see A/CN.9/WG.VI/WP.33, paras. 82-108).

75. The adjustments may also take the form of additional recommendations that would apply specifically to security rights in intellectual property rights. For example, third-party effectiveness and priority issues may need to be addressed with asset-specific recommendations (see A/CN.9/WG.VI/WP.33, paras. 13-145, as well as paras. 16-25 above). Furthermore, enforcement issues in particular with respect to security rights in rights under a licence agreement may need to be addressed with asset-specific recommendations (see paras. 35-44 above). Another example of an issue that may need to be addressed with asset-specific recommendations is the issue of the law applicable to security rights in intellectual property rights (see paras. 53-57 above).

76. The Working Group may wish to consider requesting the Secretariat to prepare commentary and recommendations in the form of an annex to the *UNCITRAL Secured Transactions Guide* so as to address the above-mentioned issues.
