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Draft Annex to the UNCITRAL Legislative Guide on Secured Transactions dealing with security rights in intellectual property

Note by the Secretariat

Contents

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X. Law applicable to a security right in intellectual property

[*Note to the Working Group: For paras. 1-21, see A/CN.9/WG.VI/WP.35/Add.1, paras. 90-98, A/CN.9/667, paras. 124-128, A/CN.9/WG.VI/WP.33/Add.1, paras. 53-57, and A/CN.9/649, paras. 77-80.*]

A. Law applicable to proprietary matters

1. In many States, the conflict-of-laws rule that applies to security rights in intangible assets applies also to security rights in intellectual property. Similarly, the conflict-of-laws rules recommended in the *Guide* with respect to security rights in intangible assets also applies to security rights in intellectual property.

2. Thus, if a State enacts the conflict-of-laws recommendations of the *Guide*, without making any changes with respect to intellectual property, the law of the grantor's location would apply to the creation, third-party effectiveness, priority and enforcement of a security right in intellectual property (see recommendations 208, and 218, subparagraph (b)). The location of the grantor is defined as its place of central administration, that is, the real rather than the statutory seat, of the grantor (see recommendation 219). Of course, recommendation 4, subparagraph (b), would also apply and defer to any applicable law rule of the law relating to intellectual property that applied specifically to intellectual property.

3. The principal advantage of the grantor's law approach is that it leads to the application of a single law to the creation, third-party effectiveness, priority and enforcement of a security right. So, for example, a secured creditor that obtains a security right in all present and future intangible assets (including intellectual property) of a grantor could obtain a security right, make it effective against third parties, ascertain its priority and have it enforced by referring to the law of only one State, even if the assets have connections with several States. In particular, both registration and searching costs would in most cases be reduced, as a secured creditor would need to register and a searcher would need to search only in the State in which the grantor is located. This would reduce transaction costs and enhance certainty, a result that is likely to have a beneficial impact on the availability and the cost of credit.

4. However, international conventions that protect intellectual property generally adopt the principle of territoriality. Thus, in many States, the law applicable to ownership of intellectual property is the law of the State where the intellectual property is protected (*lex protectionis*), while the law applicable to contractual matters is the proper law of the contract (*lex contractus*). Accordingly, the law applicable to issues of protection of intellectual property rights country by country (such as the comparative rights of an intellectual property owner as against a licensee in a particular country) is the *lex protectionis*. A common example is a licence to copyrighted work transmitted routinely across national borders via satellite.

5. While there is very little precedent on the application of the *lex protectionis* to security rights in intellectual property, a conflict-of-laws rule on security rights in intellectual property must take into account the *lex protectionis*, as a security right in intellectual property could not be created, made effective against third parties and

be enforced in a country where the encumbered intellectual property right does not exist. This would be necessary in particular to the extent that, under law relating to intellectual property, a secured creditor may be treated as a transferee. In any case, if an approach based on the law of the grantor's location were to be followed, in the case of a priority conflict between a security right in intellectual property and the ownership right of an outright transferee of the encumbered intellectual property, as outright transfers would still be governed by the *lex protectionis*, such an approach would not refer to one single law to resolve a priority conflict between the rights of a secured creditor and an outright transferee.

6. As already mentioned, in order for a secured creditor to be able to obtain an effective and enforceable security right in an intellectual property right under the law of a State, the intellectual property right must exist under the law of that State. So, the principal advantage of the *lex protectionis* is that, in recognition of the principle of territoriality adopted in international conventions on the protection of intellectual property, it would result in the same law applying to both security rights and ownership rights in intellectual property.

7. However, there are also disadvantages in applying the *lex protectionis* as the applicable law for security rights, especially in transactions in which the encumbered assets are not limited to intellectual property that is used and protected under the law of a single State. The advantages and disadvantages of the two approaches mentioned above may be illustrated with the following examples dealing separately with creation, third-party effectiveness, priority and enforcement issues.

8. Intellectual property owner A located in State X creates, pursuant to a single security agreement, a security right in its patent, trademark and copyright portfolio, protected under the laws of States X and Y, in favour of secured creditor SC1 located in State Y. Under the law of the grantor's location approach, for the creation of its security right (i.e. its effectiveness between the grantor and the secured creditor), A and SC1 need to meet the requirements of State X. Under the *lex protectionis* approach, A and SC1 have to meet the creation requirements of State X with respect to the rights protected under the laws of State X and the requirements of State Y with respect to the rights protected under the laws of State Y. If they fail to do so, the security agreement may achieve only part of its intended purpose, that is, create a security right under the law of State X, but fail to create a security right under the law of State Y.

9. When the differences between the laws of States X and Y with respect to the creation of a security right are only a matter of form (as when, for example, State X that has not enacted the recommendations of the *Guide* requires more formalities in a security agreement than does State Y that has enacted the recommendations of the *Guide*), this difficulty can be overcome by preparing the security agreement so that it satisfies the requirements of the most stringent State. Even that will create additional costs for the transaction. When States X and Y have inconsistent requirements with respect to formalities, though, this approach will not suffice. Similarly, when the agreement contemplates multiple present and future intellectual property rights as encumbered assets, difficulties cannot be overcome when some of the relevant States have enacted the recommendations of the *Guide* (allowing a single security agreement to create security rights in multiple present and future assets), while other States do not allow a security agreement to create a security right in assets not yet in existence or not yet owned by the grantor or do not allow

multiple assets to be encumbered in the same agreement. As creation of a security right means its effectiveness between the grantor and the secured creditor (and not as against third parties), the policy that underlies the *lex protectionis* does not appear to dictate referring the creation of a security right to that law.

10. In order to make its security right effective against third parties, under the grantor's location approach, it would be sufficient for secured creditor SC1 to meet the third-party effectiveness requirements of State X. Any potential creditors of intellectual property owner A would need to search only in the relevant registry in State X. Under the *lex protectionis* approach, however, secured creditor SC1 would need to meet the third-party effectiveness requirements of States X and Y to make its security right in intellectual property rights effective against third parties in States X and Y. This would possibly necessitate the filing of multiple notices with respect to the security right in the relevant registries of those States; and potential creditors would have to search in all those registries. Of course, this disadvantage would be alleviated if there were an international registry in which notices with respect to security rights, the third-party effectiveness of which is governed by different States, could be registered. This situation could be further complicated by the fact that some of those States might utilize the general security rights registry for such notices, other States might provide the option of utilizing a specialized registry, and still other States, might utilize an intellectual property registry that is mandatory under recommendation 4, subparagraph (b). However, if secured creditor SC1 has to register a notice of its security right in a patent registry, such registration can only take place in the patent registry in the State in which the patent is registered. It cannot take place in the patent registry in State Z in which the patent is not protected.

11. If intellectual property owner A creates another security right in its patent and trademarks protected in State Y in favour of secured creditor SC2, there will be a priority conflict between the security rights of SC1 and SC2 in the patents and trademarks protected in State Y. Under the law of the grantor's location approach, this priority conflict would be governed by the law of the State in which the grantor is located, that is, State X. Under the *lex protectionis* approach, however, this priority conflict would be governed by the laws of State Y. In particular in situations in which third-party effectiveness is established by way of registration in a specialized registry, the State in which the intellectual property right is registered would be the State whose law would be the most appropriate to resolve priority disputes.

12. Another example will illustrate how the law of the grantor's location will apply in the case of multiple transfers in a chain of title, where the transferor and each transferee create security rights. A, who is located in State X, owns a patent in State X. Owner A grants a security right in the patent to secured creditor SC1. A then transfers the patent to B, who is located in State Y and who grants a security right to SC2. Whether transferee B obtains the patent subject to the security right of SC1 will be determined in accordance with the law of State X, the law of the grantor's location. If B takes the patent subject to the security right, then SC2 acquires no more rights than B had. If B assigns the patent to C, who is located in State Z and who grants a security right to SC3, C and SC3 will not acquire more rights than B had.

13. In the example mentioned in the preceding paragraph, if grantor A is located in State X and the patent is protected in State Y, application of the law of the grantor's location will not allow SC1 to obtain an effective security right with priority over the rights of the transferee because the patent does not exist in State X. Only the application of the *lex protectionis* will allow SC1 to obtain an effective security right in the patent with priority over the rights of transferee B.

14. Finally, if intellectual property owner A does business in States X, Y and Z and uses a particular trademark under the laws of each of those States, those trademark rights may well have greater value taken together than they do separately because they operate collectively. Thus, if A grants a security right in those trademark rights, secured creditor SC1 would likely prefer to dispose of them together upon A's default because such a disposition would likely yield greater proceeds (thus also benefitting A). Yet, this is likely to be difficult or impossible if States X, Y and Z have different rules for disposition of encumbered assets that are intellectual property rights. If State X allows judicial disposition, while States Y and Z allow non-judicial disposition by the secured creditor, disposition of the trademark rights in a single transaction might be impossible. Even if all of the relevant States allow non-judicial disposition, though, the differences in required procedures may make disposition of the rights in a single transaction inefficient at best.

15. Moreover, enforcement of a security right is not a single event; rather it is a series of actions. So, upon A's default, secured creditor SC1, located in State Y, may notify A, located in State X that the security right in its trademark right protected under the laws of State Z is in default. Secured creditor SC1 may then advertise the disposition of the trademark right in States X, Y and Z; indeed, it may advertise the disposition worldwide by use of the Internet. Secured creditor SC1 may then identify a buyer located in State Z, who buys the encumbered asset pursuant to a contract governed by the laws of State X. Under the *lex protectionis* approach, secured creditor SC1 would need to enforce its security right in the trademark protected in State X in accordance with the law of State X, its security right in the trademark protected in State Y in accordance with the law of State Y and its security right in the trademark protected in State Z in accordance with the law of State Z. Under the grantor's law approach, enforcement of the security right in the trademark would be governed by the law of the State in which the grantor, that is A, has the place of its central administration. Of course, no matter which approach is followed, if secured creditor SC1 sells the encumbered trademarks, the transferee has to register its rights in the trademark registry of the State in which the trademark is registered and protected, that is States X, Y and Z.

16. However, another example may illustrate the importance of the *lex protectionis* approach. In the previous example, A's patents may have only been issued in State Y but not in State X. Under the law of State X (the State of the grantor's location), for a security right in a patent to be effective against third parties, it must be registered in the national patent registry. If State Y has a law of location of the grantor rule (referring to the law of State X) to determine third-party effectiveness and priority of a security right, then A could not grant B an effective and enforceable security right in its patents in State Y because in State X the patent is not protected and no registration of a security right is possible in a non-existent patent. If grantor A were located in State Y, then A could grant B such a security right, because in State Y the patent exists and a security right may be registered in the patent registry. This

example illustrates that intellectual property does not exist "in the abstract" but rather is a legal right supported by a specific national legal system, which must of necessity be responsible for its recognition and enforcement against third parties within the borders of a national jurisdiction.

17. Where grantor A, located in State X, grants a security right in a patent registered in the national patent office in State Y and then grantor A becomes insolvent, the law applicable to the creation, third-party effectiveness, priority and enforcement of the security right will be the law of State X or Y, depending on whether a grantor's law approach or a *lex protectionis* approach is followed in the forum State. Under the *Guide*, the application of any of these laws is subject to the *lex fori concursus* with respect to issues such as avoidance, treatment of secured creditors, ranking of claims or distribution of proceeds (see recommendation 223). Where the insolvency proceeding is opened in State X in which the grantor is located, the *lex fori concursus* and the law of the grantor's location will be the law of one and the same jurisdiction. Where the insolvency proceeding is opened in another State, where, for example, the grantor has assets, that may not be the case.

18. To combine consistency with the law applicable to ownership rights and the benefit of the application of a single law for security rights issues, the *lex protectionis* could be combined with the law of the grantor's location in the sense that creation and enforcement of a security right could be referred to the law of the grantor's location, while third-party effectiveness and priority could be referred to the *lex protectionis*.

19. Other combinations of the two approaches might be possible. For example, the approach based on the law of the grantor's location could be subject to a variation whereby a priority conflict involving the rights of an outright transferee would be governed by the *lex protectionis*. With this variation, a secured creditor would also need to establish its right under the *lex protectionis* only in instances where a competition with an outright transferee is a concern. In the typical case where the insolvency of the grantor is the main concern, it would be sufficient for the secured creditor to rely on the law of the State in which the grantor is located, as would be the case for certain other categories of intangible assets (such as receivables). The problem with this approach would be that, to ensure priority over potential outright transferees, secured creditors would need to establish their rights under the *lex protectionis* in any case.

20. A further variation would be to defer to the *lex protectionis* only where that law provides that the intellectual property concerned may be registered in an intellectual property registry. This further variation might, however, be unsatisfactory for outright transferees of intellectual property not subject to registration under the *lex protectionis*. They would have to investigate the law of the State of the grantor's location to ensure that their transfer is not subject to a previous security right. This approach would not provide sufficient certainty as to the law applicable.

[*Note to the Working Group: The Working Group may wish to consider the following alternatives:*

Alternative A

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

Alternative B

The law should provide that the law applicable to the creation and enforcement of a security right in intellectual property 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 intellectual property is the law of the State [or region] in which the intellectual property 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 intellectual property 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 intellectual property is protected.]

B. Law applicable to contractual matters

21. 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).

XI. The impact of insolvency of a licensor or licensee of intellectual property on a security right in that party's rights under a licence agreement

[*Note to the Working Group: The Working Group may wish to note that Working Group V (Insolvency Law) prepared the Legislative Guide on Insolvency Law (the "Insolvency Guide") culminating with its adoption by UNCITRAL on 25 June 2004 and endorsement by the General Assembly on 2 December 2004. Working Group VI (Security Interests) prepared the Legislative Guide on Secured Transactions (the "Secured Transactions Guide") culminating with its adoption by the Commission on 14 December 2007 and endorsement by the General Assembly on 11 December 2008.*

Throughout the preparation of both Legislative Guides, Working Groups V and VI worked in close coordination so that the final products would be not only compatible but also consistent with each other. In fact, two joint sessions of Working Groups V and VI were held to discuss and resolve crossover issues. As a result, the Insolvency Guide and the Secured Transactions Guide are fully compatible.

The same process of coordination between Working Groups V and VI has occurred in regard to the preparation of the draft Annex to the Secured Transactions Guide dealing with security rights in intellectual property. The underlying principle has been to maintain the integrity of the Guides previously prepared and to provide explanatory text where needed in preparation of the draft Annex. The present working paper has been prepared pursuant to the request of Working Groups V and VI.

The Working Group may wish to consider whether paragraphs 1-4 below (properly adjusted and supplemented with references to further considerations by Working Group V and Working Group VI) should be placed in the discussion of the background of the draft Annex (see A/CN.9/WG.VI/WP.37, paras. 1-8). The Working Group may wish to note that the background of the UNCITRAL Legislative Guide on Secured Transactions is set out in a preface (and not in chapter XII on the impact of insolvency on a security right).

1. At its thirteenth session (New York, 19-23 May 2008), Working Group VI considered a note by the Secretariat entitled "Security rights in intellectual property rights" (A/CN.9/WG.VI/WP.33 and Add.1). That note included a brief discussion of insolvency-related matters. At that session, the Working Group decided to revisit those matters at a future meeting and to recommend to the Commission that Working Group V (Insolvency Law) be requested to consider those matters (see A/CN.9/649, para. 103).

2. At its forty-first session (New York, 16 June-3 July 2008), the Commission noted the decision of Working Group VI and decided that Working Group V should be informed with respect to issues involving security rights in intellectual property that implicate insolvency law and invited to express a preliminary opinion (see A/63/17, para. 326).

3. At its fourteenth session (Vienna, 20-24 October 2008), Working Group VI referred to Working Group V certain matters relating to the impact of insolvency on a security right in intellectual property (see A/CN.9/667, paras. 129-143).

4. At its thirty-fifth session (Vienna, 17-21 November 2008), Working Group V reviewed the issues involving insolvency law referred to it by Working Group VI for inclusion in the draft Annex and confirmed that the responses given in the table at the end of document A/CN.9/667 accurately reflected the impact of the Insolvency Guide. In that connection, it was suggested that those considerations might be included in a commentary to be prepared. With respect to the possibility that a licensee under a licence agreement rejected by the insolvency representative of the licensor might be permitted, under some laws, to continue to exercise its rights under that agreement notwithstanding the rejection, the Working Group agreed that it was not in a position to properly consider that question without a better understanding of the scope and extent of the issues involved and requested the Secretariat to prepare a working paper, for consideration at its next session, that would provide background information on the discussion of the treatment of contracts that had taken place in the course of the development of the Insolvency Guide and the recommendations that had been adopted. Working Group V reached the same conclusion with respect to the issue of whether a secured creditor could request the licensor's insolvency representative or the insolvency court to set a deadline within which the insolvency representative should decide whether to *continue or reject a licence agreement and set a special hearing before the insolvency court to address any dispute (see A/CN.9/666, 112-117).*]

A. General

22. A licensor or a licensee of intellectual property under a licence agreement may create a security right in its rights under the licence agreement. If the grantor is the licensor, typically its secured creditor will have a security right in the licensor's right to receive royalties from the licensee as well as the right to enforce non-monetary terms of the licence agreement and the right to terminate the license agreement upon breach. If the licensee is the grantor, typically its secured creditor will have a security right in the licensee's right to use the licensed intellectual property under the licence agreement (subject to the terms of the licence agreement), but not a security right in the intellectual property itself. The secured creditor may then take the steps necessary to make that security right effective against third parties (see Secured Transactions Guide, recommendation 29).

23. Insolvency law, subject to avoidance actions, will typically respect the effectiveness of such a security right (see Insolvency Guide, recommendation 88). Similarly, insolvency law, subject to any limited and clearly stated exceptions, will respect the priority of a security right that is effective against third parties (see Secured Transactions Guide, recommendations 238-239). However, if the licensor or the licensee becomes subject to insolvency proceedings, there may be an effect on the rights of the parties to the licence agreement that will have an impact on a security right granted by the licensor or the licensee. In the case of a chain of licence and sub-licence agreements, the insolvency of any party in the chain will have an impact on several other parties in the chain and their secured creditors (e.g. an insolvency of a party in the middle of the chain will affect subsequent sub-licenses and sub-licensors, but not previous ones).

24. Outside of insolvency, there may be statutory or contractual limitations on the ability of the licensor and the licensee to grant and enforce a security right in a right to receive payment of royalties (i.e. a receivable). Secured transactions law will typically not affect statutory limitations, other than mainly those relating to a future receivable as such. Secured transactions law may affect contractual limitations (see Secured Transactions Guide, recommendations 18 and 23-25). What effect, if any, an insolvency proceeding may have on those limitations on the assignment of receivables independent of secured transactions law is a matter of insolvency law (see Insolvency Guide, recommendations 83-85).

25. The Insolvency Guide contains extensive recommendations concerning the impact of insolvency proceedings on contracts with respect to which both the debtor and its counterparty have not fully performed their obligations under the contract (see Insolvency Guide, recommendations 69-86). A licence agreement could be such a contract, if it has not been fully performed by both parties and the term of the licence agreement is not completed (so that there is remaining performance by the licensor). However, a licence agreement is not such a contract, if it has been fully performed by the licensee through an advance payment of the entire amount of the royalties owed by the licensee to the licensor, as may be the case in the event of an exclusive licence agreement, and the absence of any ongoing obligations of the licensor. The insolvent debtor could be the licensor (owing the licensee the right to

use the licensed intellectual property in line with the licence agreement) or the licensee (owing payment of royalties and the obligation to use the licensed intellectual property in accordance with the licence agreement).

26. Under the recommendations of the Insolvency Guide, the insolvency representative may continue or reject a licence agreement as a whole, if it has not been fully performed by both parties (see Insolvency Guide, recommendations 72-73). In the case of a one licence agreement, continuation or rejection of the licence agreement by the insolvency representative of one party will affect the rights of the other party. In the case of a chain of licence and sub-licence agreements, continuation or rejection will affect the rights of all subsequent parties in the chain. Finally, in the case of cross-licensing agreements (where a licensor grants a licence, the licensee then further develops the licence and grants a licence in the further developed licensed product to the licensor), continuation or rejection will affect each party both in its capacity as licensor and licensee.

27. If the insolvency representative chooses to continue a licence agreement, which has not been fully performed by both parties and as to which the insolvent debtor (licensor or licensee) is in breach, the breach must be cured, the non-breaching counterparty must be substantially returned to the economic position that it was in before the breach, and the insolvency representative must be able to perform the licence agreement (see Insolvency Guide, recommendation 79). In this case, the insolvency proceedings will have no impact on the legal status of a security right granted by the licensor or the licensee. However, if the insolvency representative chooses to reject the licence agreement, there will be an impact on a security right granted by the licensor or the licensee (for a full understanding of the treatment of contracts in the case of insolvency, the reader is referred to the text of the Insolvency Guide).

B. Insolvency of the licensor

28. If the licensor’s insolvency representative decides to continue a licence agreement, there will be no impact on a security right granted by the licensor or the licensee. If the licensor is the insolvent debtor and has granted a security right in its rights under the licence agreement, and the licensor’s insolvency representative decides to continue the licence agreement, the licence agreement will remain in place, the licensee will continue to owe royalties under the licence agreement and the licensor’s secured creditor will continue to have a security right in those royalty payments. In this case of the licensor’s insolvency, if the licensee has granted a security right in its rights under the licence agreement, the licensor will continue to owe the licensee unimpeded use of the licensed intellectual property under the licence agreement and the licensee’s secured creditor will continue to have a security right in the licensee’s rights under that agreement.

29. However, if the licensor’s insolvency representative decides to reject the licence agreement, there will be an impact on a security right granted by the licensor or the licensee. If the licensor has granted a security right in its rights under the licence agreement, the licence agreement will no longer be effective, the licensee will no longer owe royalties under the licence agreement, and, thus, there will be no royalties for the licensor’s secured creditor to be able to apply to satisfy the secured

obligation. In this case of the licensor's insolvency, if the licensee has granted a security right in its rights under the licence agreement, the licensee will no longer have the authority to use the licensed intellectual property and its secured creditor will lose its security right in the encumbered asset (i.e. the licensee's authority to use the licensed intellectual property).

30. As a practical matter, a secured creditor with a security right in a licensor's rights under a licence agreement may protect itself from the consequences of a rejection of the licence agreement by the licensor's insolvency representative by, for example, obtaining (and making effective against third parties), in addition to a security right in the licensor's rights under the licence agreement (principally the royalties), a security right in the licensed intellectual property itself. Then, if the insolvency representative of the licensor rejects the licence agreement, the secured creditor of the licensor (subject to the stay and any other limitations imposed by insolvency law on the enforcement of security rights in insolvency proceedings) can enforce its security right in the licensed intellectual property by disposing of it or by entering into a new licence agreement with a new licensee similar to the licence that had been rejected and thus re-establishing the royalty stream (see recommendation 149 of the Secured Transactions Guide). The funds received from the disposition of the encumbered intellectual property or the royalties received pursuant to this new licence agreement would then be distributed to the secured creditor pursuant to recommendations 152-155 of the Secured Transactions Guide. As a practical matter, however, this arrangement would be worthwhile only for significant licence agreements.

31. Similarly, a secured creditor with a security right in a licensee's rights under a licence agreement may seek to protect itself from the consequences of a rejection of the licence agreement by the licensor's insolvency representative, by, for example, declining to make the secured loan unless the licensee obtains and makes effective against third parties a security right in the licensed intellectual property to secure the licensee's rights under the licence agreement. Then, if the insolvency representative of the licensor rejects the licence agreement, the licensee (subject to the stay and any other limitations imposed by insolvency law on the enforcement of security rights in insolvency proceedings) can enforce the security right in the licensed intellectual property itself by disposing of it or by entering into a new licence agreement with a new licensor, and the rights thereby obtained would be proceeds in which the secured creditor would have a security right. As a practical matter, this arrangement would be worthwhile only for significant licence agreements.

32. As already mentioned, if at least one party has fully performed its obligations with respect to a licence agreement, the license agreement is not subject to the recommendations of the Insolvency Guide concerning treatment of contracts. Where neither the licensor nor the licensee has fully performed its obligations under the license agreement, however, the license agreement would be subject to rejection under those recommendations. To protect long-term investments of licensees and in recognition of the fact that a licensee may depend on the use of rights under a licence agreement, some States have adopted rules that give additional protection to a licensee (and, in effect, its secured creditor) in the case of a licence agreement that would otherwise be subject to rejection in the insolvency of the licensor. Such protection is particularly important where there is a chain of licence and sub-licence

agreements and thus several parties may be affected by the insolvency of one party in the chain.

33. For example, some States give a licensee the right to continue to use the licensed intellectual property, following the rejection of the licence agreement by the licensor's insolvency representative, as long as the licensee continues to pay royalties to the estate as provided in the licence agreement and otherwise continues to perform the licence agreement. The only obligation imposed upon the licensor's estate as a result of this rule is the obligation to continue honouring the intellectual property licence, an obligation that does not impose upon the resources of the licensor's estate. This approach has the effect of balancing the interest of the insolvent licensor to escape affirmative burdens under the licence agreement and the interest of the licensee to protect its investment in the licensed intellectual property.

34. In other States, licence agreements may not be subject to rejection under insolvency law because: (a) a rule that excludes the leases of immovable property from insolvency rules on rejection in the case of the lessor's insolvency applies by analogy to licence agreements in the licensor's insolvency; (b) licence agreements relating to exclusive licences create property rights (rights *in rem*) that are not subject to rejection (but may be subject to avoidance); (c) licence agreements are not regarded as contracts that have not been fully performed by both parties as the licensor has already performed its obligations by granting the licence. In these States, the licensee may be able to retain the licence as long as it pays the royalties owed under the licence agreement.

35. In yet other States, licence agreements may be rejected, subject to the application of the so called "abstraction principle". Under this principle, the licence does not depend on the effectiveness of the underlying licence agreement. Thus, the licensee may retain the right to use the licensed intellectual property, even if a licence agreement has been rejected by the licensor's insolvency representative. However, the licensor's insolvency representative has a claim for the withdrawal of the licence based on the principle of unjust enrichment. Until such withdrawal, the licensee has to pay for the use of the licensed intellectual property on the basis of the principle of unjust enrichment an amount equal to the royalties owed under the licence agreement that was rejected.

[*Note to the Working Group: The Working Group may wish to note that paragraph 36 is placed within square brackets as the issue discussed therein has not been considered by Working Group V.*]

36. [To protect long-term investments and expectations of licensees and their creditors from the ability of the licensor's insolvency representative in effect to renegotiate licence agreements existing at the commencement of insolvency proceedings, States might wish to consider adopting rules similar to those described in the preceding paragraphs. Any such rules would have to take account of the general rules of insolvency law and the overall effect on the insolvency estate, as well as law relating to intellectual property.]

C. Insolvency of the licensee

37. If the licensee is the insolvent debtor and has granted a security right in its rights under the licence agreement, and the licensee's insolvency representative decides to continue the licence agreement, the licence agreement will remain in place, the licensee will continue to have its rights under the licence agreement to use the licensed intellectual property (to the extent stated in the licence agreement) and the licensee's secured creditor will continue to have a security right in those rights. In this case, if the licensor has granted a security right in its rights to receive royalties under the licence agreement, the licensor's secured creditor will continue to have a security right in the licensor's right to receive the royalties.

38. In cases in which the licensee's insolvency representative decides to reject the licence agreement, however, and the licensee has granted a security right in its rights under the licence agreement, the licence agreement will no longer be effective, the licensee will no longer have a right to use the licensed intellectual property and the licensee's secured creditor will not be able to use the value of the licensee's rights under the licence agreement to satisfy the secured obligation. In this case too, if the licensor has granted a security right in its right to receive royalties under the licence agreement, the licensor will lose its royalty stream and its secured creditor will lose its encumbered asset.

39. A secured creditor with a security right in a licensor's or licensee's rights under a licence agreement may seek to protect itself from the consequences of a rejection of the licence agreement by the licensee's insolvency representative by adopting comparable measures as described above (see paras. 9-10).

40. In the case of the insolvency of the licensee, it is important to ensure that the licensor either receive its royalties and the licensee otherwise performs the licence agreement, or has a right to terminate the licence agreement. Insolvency law rules, such as those relating to curing any default of the licence agreement in the event that the licence agreement is continued (see para. 6 above) are essential. In addition, in situations where the insolvent licensee has granted a security right in its rights to receive sub-royalties, those sub-royalties will likely be a source of funds for the licensee to pay the royalties that it owes to the licensor. If the licensee's secured creditor claims all the royalties and the licensee does not have another source for payment of royalties to the licensor, it is essential that the licensor has a right to terminate the license to protect its rights.

Appendix

	Licensor is insolvent	*Licensee is insolvent*
Licensor grants a security right in its rights under a licence contract (primarily the right to receive royalties)	Question: What happens if the licensor or its insolvency administrator decides to continue the performance of the licence contract under the insolvency law (see recommendations 69-86 of the *UNCITRAL Legislative Guide on Insolvency Law*)?[a]	Question: What happens if the licensee or its insolvency representative decides to continue the performance of the licence contract under the insolvency law (see recommendations 69-86 of the *UNCITRAL Legislative Guide on Insolvency Law*)?
	Answer: The licensee continues to owe royalties under the licence contract and the secured creditor of the licensor continues to have a security right both in the licensor's right to royalties under the licence contract and in the proceeds of that right, in other words, any royalty payments that are paid.	Answer: The licensor continues to have a right to receive royalties under the licence contract and thus the secured creditor of the licensor continues to have a security right both in the licensor's right to royalties under the licence contract and in the proceeds of that right, in other words, any royalty payments that are made.
	Question: What happens if the licensor or its insolvency administrator rejects the licence contract under the insolvency law (see recommendations 69-86 of the *UNCITRAL Legislative Guide on Insolvency Law*)?	Question: What happens if the licensee or its insolvency administrator rejects the licence contract under the insolvency law (see recommendations 69-86 of the *UNCITRAL Legislative Guide on Insolvency Law*)?
	Answer: The licensee does not owe royalties under the licence contract with respect to periods after rejection, but still owes any unpaid royalties for periods before rejection; the secured creditor of the licensor thus has a security right in the right to collect such royalties for periods prior to the rejection and in the royalties paid for those periods, but has no security right in rights to any future royalties because there will be no future royalties under the rejected contract.	Answer: The licensee does not continue to owe royalties under the licence contract with respect to periods after rejection, but still owes any unpaid royalties for periods before rejection; the secured creditor of the licensor thus has a security right in the right to collect such royalties for periods prior to the rejection and in the royalties paid for those periods, but has no security right in rights to any future royalties because there will be no future royalties under the rejected contract.
Licensee grants a security right in its rights under a licence contract (primarily the right to use the intellectual property)	Question: What happens if the licensor decides to continue the performance of the licence contract under the insolvency law (see recommendations 69-86 of the *UNCITRAL Legislative Guide on Insolvency Law*)?	Question: What happens if the licensee decides to continue the performance of the licence contract under the insolvency law (see recommendations 69-86 of the *UNCITRAL Legislative Guide on Insolvency Law*)?
	Answer: The licensee continues to have rights under the licence contract and the secured creditor of the licensee continues to have a security right in those rights under the licence contract.	Answer: The licensee continues to have rights under the licence contract and the secured creditor of the licensee continues to have a security right in those rights under the licence contract.
	Question: What happens if the licensor or its insolvency administrator rejects the licence contract under the insolvency law (see recommendations 69-86 of the *UNCITRAL Legislative Guide on Insolvency Law*)?	Question: What happens if the licensee or its insolvency administrator rejects the licence contract under the insolvency law (see recommendations 69-86 of the *UNCITRAL Legislative Guide on Insolvency Law*)?

	Licensor is insolvent	*Licensee is insolvent*
	Answer: The licensee does not have rights under the licence contract with respect to periods after rejection, but retains any rights it may still have with respect to periods before rejection; the secured creditor of the licensee continues to have a security right in those rights of the licensee with respect to periods before rejection.	Answer: The licensee does not have rights under the licence contract with respect to periods after rejection, but retains rights it may still have with respect to periods before rejection; the secured creditor of the licensee continues to have a security right in those rights of the licensee with respect to periods before rejection.

[a] United Nations publication, Sales No. E.05.V.10.