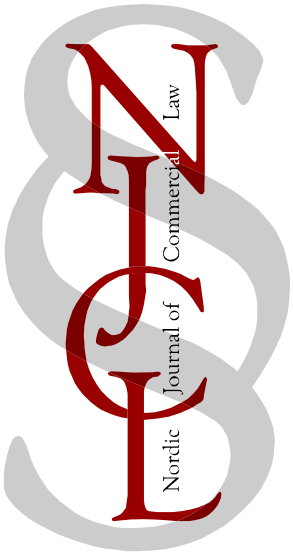

INTELLECTUAL PROPERTY & SECURITY INTERESTS: A US PERSPECTIVE*

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* This publication provides information and comments on legal issues and developments of interest. The foregoing is not a comprehensive treatment of the subject matter covered and is not intended to provide legal advice. Readers should seek specific legal advice before taking any action with respect to the matters discussed herein.

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I. Introduction

It is no secret that intellectual property can be a valuable business asset. As I.B.M.'s CEO, Samuel Palmisano, said, "[I]ntellectual property is the crucial capital in a global knowledge economy."[1] Expressing the same sentiment, a recently published article states that the "driving force behind many of the mergers and acquisitions completed during the past decade has been the acquirer's desire to obtain the target's IP assets. Now, more than ever, the full financial potential of IP is being realized as an additional source of funding to facilitate research and development, acquisitions, and other commercial transactions."[2]

Despite this, a basic business transaction involving intellectual property, a secured loan, has many traps for the imprudent attorney or lender. The American Bar Association Task Force on Security Interests in Intellectual Property concluded that "[t]he current state of the law governing security interests in intellectual property is unsatisfactory. There is uncertainty as to where and how to file, what constitute notice of a security interest, who has priority, and what properly is cover by a security interest."[3]

Reform of American laws has been long advocated in order to reduce uncertainty, but progress has been slow. As such, this article intends to inform foreign attorneys of the basic problems when securing a loan with intellectual property collateral under United States law.

II. Security Interests Basics

The two most basic but important principles of secured lending is attachment and perfection. A security interest must 'attach' to the collateral to be enforceable against the debtor and be 'perfected' to have, among other advantages, constructive notice and superior rights to the secured collateral in relation to all non-secured creditors. Thus, when perfected, the secured creditor can avoid the otherwise potent powers of a trustee-in-bankruptcy. The method of attaching and perfecting a security interest is usually governed by state law, which is modeled after Article 9 of the Uniform Commercial Code (UCC). To accomplish attachment, a debtor usually signs a security agreement, which identifies the creditor and the debtor, describes the

[1] Steve Lohr, Hoping to Be a Model, I.B.M. Will Put Its Patent Filings Online, N.Y. Times, September 26, 2006, at C5.
[2] Scott J. Lebson, *Trade secrets as collateral: a US perspective*, Journal of Intellectual Property Law & Practice, 2007, Vol. 2, No. 11.
[3] Task Force on Security Interests in Intellectual Property, Business Law Section, American Bar Association, Preliminary Report 1 (June 1, 1992).

collateral, and contains a grant by the debtor of a security interest to the creditor.[4] The debtor must also have received something of value in exchange for the security interest and have rights to the collateral.[5]

In most cases, perfection is accomplished by filing a UCC-1 financing statement in the appropriate state office, usually the state where the debtor or the collateral is located.[6] A financing statement is required to name the debtor and creditor and describe the collateral.[7] A creditor can simply use the phrase, "all of the debtor's general intangibles," to take a blanket lien on all of a debtor's intellectual property and need not identify the individual intellectual property assets.[8] "General intangibles" is a catch-all phrase that covers any type of collateral not specifically categorized by Article Nine, such as intellectual property.[9]

Unfortunately, perfection is not so easily achieved with intellectual property collateral. Because federal law govern many aspects of intellectual property, the state rules concerning perfection may be preempted when federal laws require filing a security interest (or other instruments) with a federal records office. This article will detail the contours of preemption in relation to perfecting security interests, the potential problems it presents for the creditor, and possible solutions. As explained below, in general, the safest way to secure intellectual property collateral is to file a financing statement in both the appropriate state and federal offices.

III. Patents

Although patents can be potentially the most valuable form of a company's intellectual property, the "best" way to perfect a security interest in patent collateral is not clear. US case law, however, has consistently held that filing a UCC-1 financing statement with the appropriate state office will assure priority over other lien creditors (i.e. non-title holders).[10] Problems arise when subsequent bone fide[11] purchasers (BFPs) or mortgagees are considered. More specifically, a creditor who records only a UCC-1 financing statement in a state office may have no way of preventing the debtor from selling or mortgaging the patent out from under it, free of its security interest.[12]

I use 'may' as there has yet to be a case deciding priority between a secured party and a BFP or mortgagee, but several courts have considered the issue in *dicta*.[13] One court opined that if a

[4] *See* UCC § 9-203.
[5] *Id.*
[6] UCC § 9-301.
[7] UCC §§ 9-516 & 9-504.
[8] UCC § 9-504.
[9] UCC § 9-106.
[10] See generally In re Phoenix Systems & Components, Inc., 47 B.R. 264 (D. Neb. 2007); In re Cybernetic Servs., 252 F.3d 1039 (9th Cir. 2001); City Bank & Trust Co. v. Otto Fabric, Inc. 83 B.R. 780 (D. Kan. 1988); In re Transportation Design & Tech., Inc., 48 B.R. 635 (Bankr. S.D. Cal. 1985).
[11] In this context, *bone fide* means that the purchaser or mortgagee had no knowledge of an existing security interest.
[12] Alice Haemmerli, *Insecurity Interests: Where Intellectual Property and Commercial Law Collide*, 96 Colum. L. Rev. 1645, 1703.
[13] *In re Transportation Design*, 48 B.R. at 640 ("And because § 261 [of the Patent Act] provides that only an 'assignment, grant or conveyance shall be void' as against subsequent purchasers and mortgagees [who take title],

secured creditor wishes to claim priority over a subsequent BFP or mortgagee, the secured creditor must bring its security interest within the Patent Act's Section 261,[14] which governs title transfer.[15] Accordingly, this means that a security interest must be a title interest as Section 261 records only title transfers. Further, even filing a title interest with a state office is not sufficient for perfection as a subsequent BFP will divest title if the creditor fails to record its title interest with the US Patent and Trademark Office (PTO).

In part, Section 261 states that an "assignment, grant or conveyance[16] shall be void as against any subsequent purchaser or mortgagee . . . unless it is recorded in the Patent and Trademark Office within three months from its date or prior to the date of such subsequent purchase or mortgage." Although Section 261 seems to specify as one way an assignment, grant, or conveyance may be voided, courts have interpreted it as specifying the *only* way an assignment, grant or conveyance may be voided by a competing interest.[17] For example, a previous BFP who failed to record a title transfer with the PTO will have superior rights than a subsequent secured lender who does not take title. This is so even if the creditor diligently searched the PTO files and found no recorded interests in the patent collateral and records its security interest with the PTO because *only a title interest may trump another titleholder's claim*.[18] Similarly, even though a secured creditor files his non-title interest in both the appropriate state office and the PTO, a subsequent BFP (who takes title through a conveyance from the debtor) may take a patent free of the previous security interest without even recording the title transfer with the PTO. Without title, a secured creditor does not obtain constructive notice when filing with the PTO.

The common advice in avoiding such troubles simply states, "file in both the state and federal offices,"[19] and while this is certainly sound advice, unless the security interest has a title interest, filing in the PTO may be legally ineffective. Complicating matters more, authorities are split as to

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only transfers of ownership interests need to be recorded with the PTO."); *But see In re Peregrine Entertainment, Ltd,* 116 B.R. 194, 204 (C.D. Cal 1990) (The court believed that the Patent Act fully preempts the UCC, and thus all ownership and security interests should be recorded with the PTO.).

[14] 35 U.S.C. §261.

[15] *In re Transportation Design*, 48 B.R. at 640.

[16] Courts define the terms "assignment, grant, and conveyance" as they were in 1870, when the language of Section 261 was drafted. "The historical meanings of the three terms all involved the transfer of an ownership interest. Specifically, a patent "assignment" referred to a transaction that transferred a patent's title. A "grant" also referred to a transfer of an ownership interest in a patent, but only as to a specific geographic area. A "conveyance" was defined as "to transfer the legal title from the present owner to another." Xuan-Thao Nguyen, *Security Interest in Intellectual Property and Licenses and the Revised Article 9*, 11 The Licensing Journal 9 (May 2003) (citing ***Cybernetic Servs.*** 252 F.3d at 1050.).

[17] *See Weinar v. Rollform Inc.*, 744 F.2d 797, 807 (Fed. Cir. 1984); *see also Bailey v. Chattem, Inc.*, 684 F.2d 386, 392 (6th Cir. 1982) ("The law in this Circuit is that recording does not affect the validity of a patent assignment expect as to subsequent purchasers or mortgagees without notice."); *John Truman & Sons, Inc. v. Basse*, 113 F.2d 928 (2d Cir. 1940) (The patent recording statute "does not require recording to support the validity of an assignment, except as to subsequent purchasers or mortgagees without notice, and by implication recognizes its validity as to all others.").

[18] *Id.*

[19] Reagan Harris Fibbe, *Perfecting Security Interests in IP* (2007), http://www.bakerbotts.com/infocenter/publications/ (last visited Sept. 14, 2007); Henry J. Huelsberg, III and Kevin A. White, *Is Your Secured Loan Really "Secure"? Perfecting Security Interests in IP* (2005), http://www.willcoxsavage.com/nep/articles.php (last visited Sept. 14, 2007); Paul J.N. Roy et al., *Security Interests in Technology Assets and Related Intellectual Property*, The Computer Lawyer, August 1999, at 3.

whether the potential risks of the creditor being a titleholder outweigh the gains.[20] One risk for the creditor is being named a party for patent invalidity actions.[21] A consequence for the debtor is that while it can sue for infringement and seek equitable remedies, the debtor might not be allowed to seek legal damages such as loss profits without naming the creditor as a co-plaintiff.[22]

Thus, there is no singular "best" way to perfect a security interest in a patent. Rather the underlying deal should guide whether or not to perform a title assignment. The risks created by a creditor not holding title are based on the possibility of the debtor committing a fraudulent transfer. If there is no perceived risk of this happening, then perhaps an assignment is not necessary. And in fact, transactions occur both ways.

If a title transfer is deemed appropriate, a conditional assignment may be best. That is, a debtor will hold title until default, in which title passes to the creditor. Such an assignment is treated as an absolute assignment by the PTO for purposes of filing and thus receives Section 261 protection.[23] This also results in creditor being a titleholder in name only and debtor enjoying most of the substantive rights of patent ownership, barring, though, suing for legal damages. The assignment should clearly state that this is the parties' objective and put the burden on patent maintenance (payment of fees to the PTO and other duties) on the debtor.

A similar decision is to be made when drafting the financing statement. Again, depending on the transaction, a creditor may file a blanket lien with the PTO that simply states, "All of debtor's past and future patents and patent applications are subject to creditor's security interest," or file a financing statement that identifies the patents individually by the number the PTO assigns a patent. Although the latter necessitates filing a financing statement for each new patent application and patent issued, listing the patent numbers is safer as patents are organized by number, and thus every creditor knows to search the PTO records by patent number. However, an electronic search can find PTO records by a creditor's name as well.

IV. Trademarks

"Unlike patents or copyrights, trademarks are not separate property rights. They are integral and inseparable elements of the goodwill of the business or services to which they pertain."[24] Because of this, an assignment of a trademark is void (i.e. an assignment in gross) unless it includes the "goodwill" of the underlying business associated with the mark.[25] Although, a security interest in a trademark has repeatedly been held not to be an assignment, problems can arise if a creditor attempts to foreclose without obtaining a business's goodwill.[26]

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[20] Bramson, *Intellectual Property Financing* in *Asset-Based Financing: A Transactional Guide* (H. Ruda ed.) § 31.02[3] (Advises to assigning title to creditor); Raymond T. Nimmer, *Commercial Asset Based Financing § 22.05* (Callaghan 1988) (Same); *but see* William C. Hillman, *Documenting Secured Transactions: Effective Drafting and Litigation*, § 3:11.1 ("In most cases, however, this price is small [of risk of fraudulent transfer by debtor] compared to exposure to patent invalidity actions."); Roy, *supra* note 20, at 10 (Believes that an assignment of title to a lender are risky.).

[21] Hillman, *supra* note 21, at § 3:11.1.

[22] Haemmerlli, *surpa* note 13, at 1712.

[23] 37 C.F.R. 3.56 (2005).

[24] *Visa, U.S.A., Inc. v. Birmingham Trust Nat'l Bank*, 696 F.2d 1371, 1375 (Fed. Cir. 1982).

[25] J. Thomas McCarthy, *McCarthy on Trademarks and Unfair Competition* § 18.01[7].

[26] *See Li'l Red Barn, Inc. v. Red Barn System, Inc.*, 322 F. Supp. 98 (N.D. Ind. 1972); *Marshak v. Green* 746 F.2d 927 (2d Cir. 1984); *Clark & Freeman Corp. v. Heartland Co. Ltd.*, 811 F. Supp. 137 (S.D.N.Y. 1993).

A prudent creditor has several ways to avoid such a risk if foreclosure is necessary. First, a security interests may include all goodwill associated with the mark as collateral too. By filing a financing statement that states a creditor has a security interest in all of a debtor's "general intangibles," it should cover both trademarks and related goodwill.[27] Second, a creditor may also take a security interest on "related assets associated with the products marketed under the trademark, such as accounts receivable, to make certain that in the event of foreclosure, the mere act of assignment would not in and of itself destroy the value of the collateral."[28] This technique is supported by case law as courts have traditionally viewed the transfer of tangible business assets as reflecting "goodwill."[29]

Unlike the case in patents, it is not recommended that a creditor structure the security interest as a condition assignment, that is, where a creditor would take title of the trademark upon default of the debtor. While this necessitates recording with the PTO to maintain validity, the real cause of concern is "by recordation, the conditional assignment is deemed, by law, a present transfer of title."[30] As such, "the lender must use the trademark in order to maintain the rights in the trademark, and if the lender licenses the trademark back to the borrower, the lender must actively monitor and control the borrower's use of the trademark."[31] Thus, a security interest that lacks a title interest is preferred.

The question remains as to where to file a financing statement. Just as with patents, the safest way is to file in both state and federal offices. Filing with the appropriate state office is mandatory in order to assert rights in the trademark collateral superior to other lien creditors.[32] At the federal level, assignments of trademarks, like patents, are recorded with the PTO to give notice to subsequent purchasers; however, unlike patents, trademarks do not have to be filed with the PTO to be legally recognized. Their creation and substantive rights are dictated by state law and arise out of a business's use of a mark with its goods and services. The federal law pertaining to trademarks, the Lanham Act, creates few substantive trademark rights, but establishes a registration system to record assignments and provides benefits to registrants such as constructive notice.[33] Although case law has clearly held that a security interests are distinct from assignments,[34] the PTO will nevertheless accept filing of instruments other than assignments vis-à-vis trademarks.[35] It is thus advisable to do so in order to cut-off any potential rights of subsequent BFPs or assignees.

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[27] Roy, *supra* note 20, at 12.

[28] Scott J. Lebson, *Security Interests in Intellectual Property in the United States: (Are they Really Secure?)*, http://www.ladas.com/IPProperty/ipprop_securityinterests.html (last visited Sept. 14, 2007) citing *Matter of Roman Cleanser Co.*, 802 F.2d (6th Cir. 1986).

[29] J. Thomas McCarthy, Trademarks and Unfair Competition §18:10 (2001).

[30] Deborah Ruff, *Navigating Uncharted Waters- Taking Security Interests In United States Trademarks*, http://www.securitization.net/knowledge/transactions/waters.asp (last visited Sept. 14, 2007).

[31] *Id.*

[32] *See Trimarchi v. Together Dev. Corp.*, 255 B.R. 606, 612 (D. Mass. 2000); *In re Roman Cleanser Co.*, 43 B.R. 940 (Bank. E.D. Mich. 1984).

[33] 15 U.S.C. § 1022

[34] *See, e.g., In re Roman Cleanser Co.*, 802 F.2d 207, 210 (6th Cir. 1986).

[35] Roy, *supra* note 20, at 12 (citing *In re Ellison Publications, Inc.*, 182 USPQ 498.).

V. Copyright

Although the Copyright Act and case law interpreting the Act create a federal registry for security interests in copyright collateral,[36] filing a financing statement in a state office may be necessary as well. The Copyright Act requires that any transfer of copyright ownership to be recorded with the Copyright Office.[37] Although a security interest is not normally an ownership interest, the Copyright act defines a "transfer of copyright ownership" as an "assignment, mortgage, exclusive license, or any other conveyance, alienation or *hypothecation* of a copyright . . . ."[38] Black Law's Dictionary defines hypothecate as "to pledge (property) as security or collateral for a debt, without delivery of title or possession."[39] Under this definition courts have held that perfection of security interests with copyright collateral is accomplished by filing with the Copyright Office.[40]

However, a wrinkle (and dispute among courts) is caused because copyrights come into existence at the moment a work is fixed in a tangible medium of expression.[41] Thus, while filing with the Copyright Office is necessary to enforce a copyright,[42] its creation is instantaneous. This presents two problems. First, how does a creditor perfect an interest in an unregistered copyright? Second, how does a creditor perfect an interest in subsequent modifications of a registered copyright as modifications are regarded as a new and thus unregistered work under copyright law?

To the first question, the courts are split. One side holds that it is impossible to hold a security interests in a copyright without first registering the work.[43] The other side holds that since the Copyright Act is silent as to unregistered copyrights and security interests, state law governs.[44] Thus, a creditor must file with the appropriate state office. The split also answers the second question. The first line of decisions would require both a registration of each modified work and an accompanying financing statement, while the second would allow for either a work-by-work filing with the Copyright Office or simply a blanket lien in all of debtor's general intangibles to be filed at the appropriate state office.

Thus, to get both the broadest scope of protection available and avoid the courts' discrepancies, filing at both the state and federal level is necessary.

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[36] *See In re Avalon Software Inc.*, 209 B.R. 517, 521 (Bank. D. Ariz. 1997) ("Under federal copyright law, the grant of a security interest is defined as a 'transfer of copyright ownership,' because within copyright law that term includes mortgages or other forms of hypothecation.").
[37] 17 U.S.C. § 205(a).
[38] 17 U.S.C. § 101.
[39] (8th ed. 2004).
[40] *E.g. In re Avalon Software, Inc.*, 209 B.R. 517 (Bankr. D. Ariz. 1997).
[41] 17 U.S.C. § 101.
[42] 17 U.S.C. § 411.
[43] *Avalon Software*, 209 B.R. 517; *In re AEG. Acquisition Corp.*, 127 B.R. 34 (Bankr. C.D. Cal. 1991).
[44] *In re World Auxiliary Power Co.*, 244 B.R. 149 (Bankr. N.D. Calif. 1999). All of the courts in the split cited *In re Peregrine Entertainment Ltd.*, 116 B.R. 194 (C.D. Cal.1990) as support for their rulings.

VI. Trade Secrets

On the periphery of the intellectual property landscape are trade secrets. Due to their very nature, trade secrets are of unknown length, must be maintained in confidence, and are not registered in a state or federal office. Thus, "this fundamental principle of maintaining secrecy suggests the need to proceed with extreme caution when negotiating, creating, and perfecting security interests in trade secrets."[45] A blanket lain in a debtor's intellectual property is likely perfected with a financing statement containing "language to the effect of 'all general intangibles now owned or hereinafter acquired by the debtor.'"[46] That is, the UCC does not require a financing statement to specifically identify separate intellectual property rights that fall under the general intangibles category when taking a blanket lien on a debtor's general intangibles.[47] However, if a creditor is taking an interest in only specific trade secrets, the financing statement should identify the trade secret without breaching its confidentiality. "It has also been suggested that the trade secret be held in escrow for the benefit of the secured party."[48]

VII. Domain Names

To date, there are two well known cases that have addressed whether domain names are property. If domain names are recognized as property or an analog of property, it would lend credence to the idea that a security interests can be obtained in them. In *Kremen v. Cohen*, the Ninth Circuit Court of Appeals found domain names are property.[49] In contrast, the Virginia Supreme Court in *Umbro v. 3263851 Canada Inc.*, held that "a domain name registration is the product of a contract for services between the registrar and registrant" in which a domain name, like a telephone number, does not exist separately from "its respective service that created it and that maintains its continued viability."[50] As such, one article advises:

> [B]ecause of the uncertainty in this area, a lender may want to make a state UCC-1 filing where the borrower's business is located and also in the state where the host server is located. If the domain name is particularly valuable, a lender may also want to have the debtor transfer the domain name into escrow along with a power of attorney in favor of the lender so that the lender can control the domain name in the event of the borrower's default.[51]

VIII. Conclusion

If trademarks, copyrights, or patents are identified as collateral in a security agreement, the financing statement should be filed in both the appropriate state and federal offices. In the same vein, a creditor must perform a proper search in these offices to make sure that the debtor

[45] Lebson, *supra* note 3.
[46] *Id.*
[47] *Id.*
[48] *Id.*
[49] 325 F.3d 1035 (9th Cir. 2003).
[50] 259 Va. 759, 529 S.E.2d 80 (Va. 2000).
[51] Huelsberg, *supra* note 20, at 3.

is the titleholder and for other encumbrances. Counsel should also be aware of the various issues when choosing how to structure a secured transaction (conditional assignment, lease-back, etc…) vis-à-vis the underlying intellectual property collateral. Particular care should be taken with trade secrets and domain names as authority and case law on the subject is scarce. Whether structuring a loan for a creditor or conducting due diligence for an acquisition, these issues should be addressed to save headaches in the future.