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

Note by the Secretariat

Addendum

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X. Law applicable to a security right in intellectual property

[*Note to the Commission: For paras. 1-48 and recommendation 248, see A/CN.9/WG.VI/WP.42/Add.6, paras. 1-45, and recommendation 253; A/CN.9/689, paras. 41-57; A/CN.9/WG.VI/WP.39/Add.7, paras. 1-23; A/CN.8/685, paras. 87-94; A/CN.9/WG.VI/WP.37/Add.4, paras. 1-21; A/CN.9/670, para. 115; 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 property matters

1. Purpose and scope

1. Generally, the conflict-of-laws rules recommended in the *Guide* deal with the law applicable to the creation, effectiveness against third parties, priority as against the rights of competing claimants and enforcement of a security right. They also determine the territorial scope of the substantive law rules recommended in the *Guide*, that is, if and when the substantive law rules of the State enacting the law recommended in the *Guide* apply (see the *Guide*, chap. X, paras. 1-9).

2. Chapter X of the *Guide*, Conflict of laws, does not define the security rights to which the conflict-of-laws rules recommended in the *Guide* apply. Normally, the characterization of a right as a security right for conflict-of-laws purposes reflects the substantive secured transactions law in a State. However, the *Guide* recommends that a State that enacts the law recommended in the *Guide* following a non-unitary approach to acquisition financing apply the conflict-of-laws rules governing security rights to retention-of-title rights or financial leases (see recommendation 201). Similarly, as most of the substantive law rules of the law recommended in the *Guide* that apply to security rights in receivables apply also to outright assignments, the *Guide* recommends that such a State apply the conflict-of-laws rules governing assignments of receivables for security purposes to outright assignments of receivables (see the term "security right" in the introduction to the *Guide*, sect. B, and recommendations 3 and 208).

3. In principle, a court or other authority will use its own law whenever it is required to characterize an issue for the purpose of selecting the appropriate conflict-of-laws rule. As the conflict-of-laws rules recommended in the *Guide* have been prepared to reflect the substantive law rules recommended in the *Guide*, a State that enacts both the substantive law and the conflict-of-laws rules recommended in the *Guide* will have no difficulty in applying either. If, however, a State does not enact the substantive law rules recommended in the *Guide*, it may find it difficult to apply the conflict-of-laws rules recommended in the *Guide*. This may be so if a State treats creation and third-party effectiveness as one issue, while the conflict-of-laws rules recommended in the *Guide* would treat them as two separate issues and refer them to the laws of different States. It should be noted that, following the approach followed in most States, the *Guide* draws a distinction between the agreement creating a security right as a property right (referred to a specific law; see recommendations 203 and 208) and the mutual rights and obligations of the parties flowing from such an agreement as contractual rights (typically referred to the law chosen by the parties; see recommendation 216).

4. In any case, the question whether an asset (including intellectual property) may be transferred or encumbered is a preliminary issue to be addressed before the creation of a security right and is not addressed by the conflict-of-laws rules recommended in the *Guide*. Thus, to the extent that other conflict-of-laws rules refer issues of transferability of intellectual property rights, for example, to the law of the State in which the intellectual property is protected (*lex loci protectionis* or *lex protectionis*), the *Guide* does not affect them. This is so not because the law recommended in the *Guide* defers to law relating to intellectual property, but because the law recommended in the *Guide* does not address these issues. Following the same approach, the substantive law rules recommended in the *Guide* do not override statutory limitations to transferability (see recommendation 18).

5. When the conflict-of-laws rules recommended in the *Guide* refer a matter relating to security rights to the law of a particular State, the reference is to the entire body of law in effect in that State (with the exception of its conflict-of-laws rules to avoid *renvoi*; see recommendation 221), including not only statutory and non-statutory law (see the introduction to the *Guide*, para. 19) and the law in effect in particular territorial units of a multi-unit State (see recommendations 224-227) but also legal rules in effect in that State flowing from treaties, conventions and other international obligations. Thus, for example, if a conflict-of-laws rule refers a matter relating to security rights in intellectual property to the law of a State in which the law for that matter has been promulgated by a regional economic integration organization, the reference to the law of that State includes the rules of law promulgated by the regional economic integration organization.[1] The same applies to relevant rules promulgated by international organizations, such as WIPO.

6. It should also be noted that, whatever the applicable law may be, its application will be subject to: (a) the public policy and mandatory rules of the forum (see recommendations 222); and (b) in the case of the grantor's insolvency, the impact of the application of the law of the State in which the insolvency proceedings are commenced with respect to certain insolvency-related matters (*lex fori concursus*; see recommendation 223). Finally, it should be noted that, like all the other rules recommended in the *Guide*, the conflict-of-laws rules as well do not apply in so far as they are inconsistent with national law or international agreements, to which the State is a party, relating to intellectual property, if any (see recommendation 4, subpara. (b)).

2. The approach recommended in the *Guide* with respect to security rights in intangible assets

7. Under the law recommended in the *Guide*, the law applicable to the creation, third-party effectiveness, priority and enforcement of a security right in an intangible asset is the law of the grantor's location (see recommendations 208 and 218, subpara. (b)). Following the approach followed in many States, the *Guide* has asset-specific recommendations for security rights in certain types of intangible asset, such as rights to funds credited to a bank account

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[1] For example, under article 16 of the Community Trademark Regulation 207/2009, articles 17-24 apply and only if these provisions have no specific rule, the law of the country where the proprietor has his seat, establishment (if inside the EU) or Spanish law (seat of the Office) applies.

(see recommendations 209-212), but not for security rights in intellectual property. Thus, if a State enacts the conflict-of-laws rules recommended in the *Guide*, without an asset-specific rule for intellectual property, the law of the State in which the grantor is located would apply to the creation, third-party effectiveness, priority and enforcement of a security right in intellectual property. 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). As already mentioned (see para. 6 above), recommendation 4, subparagraph (b), would also apply and, to the extent that the conflict-of-laws rules recommended in the *Guide* would be inconsistent with those of the law relating to intellectual property that applied specifically to intellectual property, the conflict-of-laws rules of the law relating to intellectual property would apply.

8. The principal advantage of an approach based on the law of the State in which the grantor is located 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 both intellectual property and other assets) 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 a single State, even if the assets have connections with several States. In particular, both registration and searching costs with respect to security rights 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 was located. This result would reduce transaction costs and enhance certainty and would thus potentially have a beneficial impact on the availability and the cost of credit.

9. Another particularly important advantage of an approach based on the law of the State in which the grantor is located and the definition of "location" as the place of central administration (see para. 7 above) is that that law is also the law of the State in which the main insolvency proceeding with respect to the grantor is likely to be administered (as to the meaning of a "main proceeding", see, for example, articles 2, subpara. (b), and 16, para. 3, of the UNCITRAL Model Law on Cross-Border Insolvency).[2] As a result, the law applicable to the creation, third-party effectiveness, priority and enforcement of a security right and the law applicable to, for example, stays, avoidance proceedings, treatment of assets and ranking of claims are likely to be the law of one and the same State. It should be noted that, while in some cases the statutory seat may be easier to determine than the real seat, referring to the statutory seat might lead to the applicable law rule being set aside for reasons of public policy or mandatory law (see recommendation 222), if the statutory seat and the place of central administration of the grantor are not in the same State. This would be the case if the law of the State of the statutory seat has provisions on the priority of a security right that are inconsistent with the insolvency law of the State in which insolvency proceedings will be opened (*lex fori concursus*). For the reasons mentioned below (see paras. 22 and 23 below), an approach based only on the law of the State in which the grantor is located would not be appropriate for security rights in intellectual property

[2] United Nations publication, Sales No. E.99.V.3.

10. It should be noted that where the grantor moves from one State to another State that has enacted the law recommended in the *Guide*, different rules apply, if the law of the State in which the grantor is located is the applicable law. According to these rules, if the grantor moves to a State that has enacted the law recommended in the *Guide*, a security right remains effective against third parties for a short period of time without any action on the part of the secured creditor and thereafter only if the third-party effectiveness requirements of the State of the grantor's new location are met (see recommendation 45).

11. For example, intellectual property owner A, located in State X, creates a security right in favour of secured creditor SC1 in a copyright protected in State Y, moves to State Y, which has enacted the law recommended in the *Guide* and creates another security in the copyright in favour of secured creditor SC2 in State Y. If State Y has enacted a rule referring priority as between secured creditors to the law of the State of the grantor's location (see recommendation 208), the security right of SC1 has priority over the security right of SC2 for a short period of time without any action on the part of SC1 and thereafter only if SC1 meets the third-party effectiveness requirements of State Y. This result is the result of a rule based on recommendation 45 and not of a conflict-of-laws rule. If A, instead of moving to State Y, transfers the copyright to transferee B in State Y, whether transferee B obtains the copyright subject to the security right of SC1 will be determined in accordance with the *lex protectionis*. Similarly, whether secured creditor SC2 takes its security right subject to the security right of SC1 will be determined in accordance with the *lex protectionis*.

12. It should also be noted that, under the law recommended in the *Guide*, the relevant time for determining the location of the grantor for creation issues is the time of the putative creation of a security right and for third-party effectiveness and for priority issues it is the time when the issue arises (see recommendation 220). As a result, under the law of the grantor's location rule recommended in the *Guide* and to the extent that rule would apply to security rights in intellectual property assets, the creation of the security right of SC1 would be subject to the law of State X and the creation of the security right of SC2 would be subject to the law of State Y. The third-party effectiveness and priority of the security right of SC1 as against transferee B and its secured creditor SC2 would, after a short period of time (see recommendation 45), be subject to the law of State Y.

3. The law of the State of protection (*lex protectionis*)

13. Although international conventions designed to protect intellectual property do not expressly address the law applicable to issues arising with respect to security rights in intellectual property, they generally adopt the principle of territoriality. Thus, in States parties to these conventions, the law applicable to ownership and issues of protection of intellectual property rights (such as the comparative rights of an intellectual property owner in one State as against a licensee or an infringer in another State) is the *lex protectionis* (see recommendation 248, option A, below). It should be noted that, with respect to types of intellectual property that are subject to registration in a national, regional or international intellectual property registry (for example, patents and trademarks), the *lex protectionis* is the law of the State (including the rules promulgated by regional or international organizations) under whose authority the registry is maintained.

14. The view is expressed[3] that the principle of national treatment embodied in international conventions protecting intellectual property implicitly imposes a universal rule in favour of the *lex protectionis* for determining the law applicable not only to ownership of intellectual property but also to issues arising with respect to security rights in intellectual property. In accordance with that view, it is asserted that provisions such as article 2, paragraph 1, of the Paris Convention for the Protection of Industrial Property (1883), article 5, paragraph 2, of the Berne Convention for the Protection of Literary and Artistic Works (1886) and article 3, paragraph 1, of the Agreement on Trade Related Aspects of Intellectual Property Rights designate that the appropriate connecting factor is the place of protection of the relevant intellectual property right.[4] In other words, according to this view, States parties to any of these international conventions are required to apply the *lex protectionis* to issues arising with respect to security rights in intellectual property.

15. As a result of this view, in order for a secured creditor to be able to obtain an effective and enforceable security right in an intellectual property right in a State in which the intellectual property right exists, the secured creditor would have to fulfil the requirements of that State. So, the principal advantage of an approach based on the *lex protectionis* is that, in recognition of the principle of territoriality adopted in international conventions for the protection of intellectual property, its application would result in the same law applying to both security rights and ownership rights in intellectual property. It should be noted that the *lex protectionis* is relevant for the creation, third-party effectiveness, priority and enforcement of a security right as a property right. It does not necessarily apply to purely contractual matters between the grantor and secured creditor that may be subject to the law governing a contract (*lex contractus*; see section B of this chapter below).

16. However, there are also inefficiencies to an approach based on the *lex protectionis* as the law applicable to security rights in intellectual property. In many transactions, registration in registries located in several States would have to take place. This will be the case, in particular with: (a) transactions in which a portfolio of intellectual property rights protected under the laws of various States is used as security for credit, (b) transactions in which the encumbered assets are not limited to intellectual property that is used and protected under the law of a single State and (c) transactions in which all assets of a grantor are encumbered. As discussed further below, such a result is likely to add to the cost and complexity of an intellectual property financing transaction by increasing registration costs. In addition, if the grantor is not located in the State under whose law the encumbered intellectual property is protected and an insolvency proceeding with respect to the grantor is commenced in the State in which it is located, referring a security right to the law of the protecting State might lead to the applicable law rule being set aside as contrary to public policy or mandatory law considerations of the *lex fori concursus* (see recommendation 222). Moreover, as long as a secured creditor can always meet the requirements of the *lex protectionis* by virtue of recommendation 4, subparagraph (b), providing for a *lex protectionis* approach may

[3] See the report of Working Group VI (Security Interests) on the work of its sixteenth session (A/CN.9/685, para. 90).

[4] These instruments may contain certain exceptions that are not considered relevant to this discussion.

unnecessarily deprive secured creditors of the choice of following the law of the grantor's location or registering in the general security rights registry and thus saving transaction costs.

4. Other approaches

17. The view mentioned above (see paras. 13-14), attributing an extensive effect to international intellectual property conventions with respect to the determination of the law applicable to issues relating to security rights in intellectual property, is not universally accepted. In addition, there is very little precedent on the application of the *lex protectionis* to issues arising with respect to security rights in intellectual property. Even assuming that these international conventions could impose conflict-of-laws rules, it would still be questionable whether the scope of application of these rules would cover all property effects contemplated by the draft Supplement, that is, the creation, effectiveness against third parties, priority as against the rights of competing claimants and enforcement of a security right in intellectual property.

18. Accordingly, even if one accepts the extensive effect of international intellectual property conventions described above (see paras. 13-14), it would still be necessary or useful for States to adopt conflict-of-laws rules applicable to issues arising with respect to security rights in intellectual property. Such rules would, at the very least, perform a gap-filling function with regard to any possible conflict-of-laws consequences resulting from existing international intellectual property conventions.

19. In view of the above-mentioned considerations, to combine consistency with the law applicable to ownership rights and the benefits of the application of a single law for security rights issues, the *lex protectionis* approach could be combined with the law of the grantor's location approach in the sense that some issues could be referred to the law of the grantor's location, while other issues could be referred to the *lex protectionis*. It should be noted, however, that referring different security-right-related issues to different laws may compromise the certainty and predictability of the law applicable to security rights and may also create inefficiencies that may negatively affect the availability and the cost of credit (see paras. 27, 29, 30, 46 and 52 below).

20. For example, the approach based on the law of the grantor's location could be subject to a variation whereby the third-party effectiveness and priority of a security right as against the rights of an outright transferee or licensee of intellectual property would be governed by the *lex protectionis* (see recommendation 248, option B, below). This rule would apply irrespective of whether or not the *lex protectionis* provides for registration of a security right in intellectual property in an intellectual property registry. 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 (because the grantor cannot pay all its creditors), 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 other types of intangible asset (such as receivables).

21. In those States that follow such an approach with respect to security rights in intellectual property, it works and results in saving transaction costs mainly for two

reasons. First, as under recommendation 4, subparagraph (b), law relating to intellectual property prevails. So, secured creditors may always register under the *lex protectionis* and in the relevant intellectual property registry. Second, in many transactions, secured creditors meet the third-party effectiveness requirements of the State in which the grantor is located or register a notice only in the general security rights registry, because their main concern is the insolvency of the grantor. They are prepared to take the risk of not registering under the *lex protectionis* or in the intellectual property registry, which would protect them against the risk of the borrower's fraud as they would not lend if they feared fraud.

22. However, such a "hybrid" approach also has disadvantages. If the secured creditor needs to ensure its priority as against all competing claimants, it would have to meet the requirements of the law that typically governs ownership in intellectual property, that is, the *lex loci protectionis*. This would be the case in particular with respect to priority as against: (a) a transferee of intellectual property; (b) an exclusive licensee of intellectual property where an exclusive licence is treated as a transfer; (c) a secured creditor that under law relating to intellectual property is treated as an owner or may exercise the rights of an owner (see A/CN.9/700, para. 30, A/CN.9/700/Add.2, paras. 10-12 and A/CN.9/700/Add.5, para. 1); and (d) an insolvency representative that is treated as an owner (recommendation 223 would not affect the law otherwise applicable to a security right, except to the limited extent it describes). Such a result could have a negative impact on the availability and the cost of credit. In addition, if the law of the State in which the grantor is located is not the law of the protecting State, the security right may not be effective and enforceable under the law of the protecting State. Moreover, as mentioned above (see para. 10), even in States in which a security right is subject to the law of the State in which the grantor is located, the *lex protectionis* may be applicable by virtue of recommendation 4, subparagraph (b). It should also be noted that, in particular if a security right may be registered in an intellectual property registry, the applicable law of the State of the grantor's location may be set aside as fundamentally contrary to the public policy and the internationally mandatory rules of the forum (see recommendation 222).

23. Furthermore, if the grantor is a transferee that has taken the asset from the initial or intermediate owner located in a State other than the State of the grantor's location, the secured creditor would have to search in the security rights registry (and possibly in the relevant intellectual property registry, if any) of any such other State. It should be noted that, in such a case, if the initial or intermediate owner had itself granted a security right that was subject to the law of the location of the initial or intermediate owner, under the law recommended in the *Guide*, the applicable law would be the law of the State in which the grantor was located at the time a priority conflict arose (see recommendations 208 and 220, subpara. (b)). Under the law recommended in the *Guide*, except in certain prescribed situations, each transferee of an encumbered asset would take the asset subject to a pre-existing security right. As a result, each transferee would take subject to a security right created by a prior owner (see recommendations 79-82).

24. Other combinations of the two approaches might also be possible. For example, issues arising with respect to a security right in intellectual property that is subject to registration in an intellectual property registry (whether national, regional or international) may be referred to the law of the State under whose authority the

registry is maintained (this approach is followed in the *Guide* with respect to security rights in tangible assets that are subject to specialized registration; see recommendation 205). An exception could be made for issues relating to enforcement that, for reasons of cost- and time-efficiency, could be referred to the law of the State in which the grantor was located. At the same time, issues arising with respect to a security right in intellectual property that is not subject to such registration may be referred to the law of the State in which the grantor is located. Again, an exception could be made for the third-party effectiveness and priority of a security right in intellectual property that could be referred to the *lex protectionis* (see recommendation 248, option C, below).

25. The main advantage of this approach is that it takes into account the existence of national, regional or international intellectual property registries and the potential reluctance of States that have such registries to adopt a conflict-of-laws rule that would disregard the existence of those registries. To the extent that legislation of regional or international organizations provides for registration of rights in intellectual property, member States of these organizations would find it difficult to adopt a rule that runs counter to regional or international legislation. For example, member States of the European Union may not be in a position to adopt a rule that failed to take into account that, under article 16 of the Community Trademark Regulation 207/2009 ("CTM Regulation"), community trademarks are subject to primarily articles 17-24 of the CTM Regulation, and, only if these provisions have no specific rule, the law of the State where the proprietor has his seat, establishment (if inside the EU) or Spanish law (seat of the Office).

26. This approach has also disadvantages. To the extent that rights in some types of intellectual property are capable of being registered in an intellectual property registry (for example, patents and trademarks), while other types are not (copyrights), it results in a different conflict-of-laws treatment of security rights in the various type of intellectual property. In addition, to the extent that the approach to the law applicable to security right in intellectual property is based on the *lex protectionis*, such an approach draws unnecessary distinctions as the *lex protectionis* coincides with the law of the State of the registry and should apply to all types of intellectual property. Moreover, to the extent that the second part of such an approach is identical with the approach discussed above, but with a more limited scope of application (see recommendation 248, option B, below), it would have all its advantages and disadvantages (paras. 20-23 above). Furthermore, such an approach may add cost and complexity to outright transfers of intellectual property rights that are not subject to such registration under the *lex protectionis*. This is so because an outright transferee of such an intellectual property right would have to investigate the law of the State of the grantor's location to ensure that the transfer was not subject to a prior security right.

27. Moreover, referring priority and enforcement to two different laws is bound to create cost, complexity and inconsistencies. For example: (a) an issue may be characterized in a State as an issue of priority and in another State as an issue of enforcement; and (b) priority may affect enforcement issues such as who has the right to take over enforcement, distribution of proceeds from a sale, rights acquired by a transferee in an extrajudicial sale. To avoid these problems, with respect to security rights in intangibles, the *Guide* recommends as the law applicable to enforcement the law applicable to priority (see recommendation 218, subpara. (b)).

Finally, this approach would require an investigation of the *lex protectionis* of all States concerned to ascertain whether those States permit registration of a security right in intellectual property in an intellectual property registry. For example, the law applicable to a security right in copyright would depend on whether the copyright may be registered in a copyright registry or not.

28. Another possible combination of the two approaches might be to refer the creation and enforcement of a security right to the law of the State of the grantor's location (or the law of the protecting State), unless the parties agreed to refer the law of the protecting State (or the law of the State of the grantor's location). Under such an approach, the third-party effectiveness and priority of a security right could be referred to the law of the State of the grantor's location, with the exception of the third-party effectiveness and priority of a security right as against the rights of a transferee, licensee or another secured creditor (see recommendation 248, option D, below). This approach would: (a) allow a limited extent of party autonomy with respect to creation and enforcement; (b) refer third-party and priority mainly to the law of the protecting State; and (c) allow the third-party effectiveness and priority of a security right as against an insolvency representative to be referred to the law of the State of the grantor's location.

29. This approach too would have disadvantages. To the extent that creation and third-party effectiveness are referred to two different laws, only States that treat these two issues as distinct issues (in other words, follow an approach like the approach recommended in the *Guide*) could apply such a rule. In addition, while under the law recommended in the *Guide*, creation of a security right produces effects only between the grantor and the secured creditor, this is currently not the case under the law of most States. Thus, such a rule would have limited application until wide adoption of law that would be consistent with the law recommended in the *Guide*. Moreover, under the law recommended in the *Guide*, creation is one of the two elements of third-party effectiveness (the other being registration or other method; see recommendation 29). As a result, before finding out what law governs creation, third parties would not be in a position to ascertain whether a registered right would have priority over their rights. This result would undermine the certainty and predictability of applicable law sought to be achieved by a conflict-of-laws rule.

30. Furthermore, referring any issue other than the mutual rights and obligations of the parties to party autonomy just with respect to security rights in intellectual property would be a departure from the approach followed in the *Guide* (see recommendation 10, which does not permit party autonomy for any applicable law issue other than the mutual rights and obligations of the parties) and from generally acceptable conflict-of-laws principles. Moreover, as already mentioned (see para. 25 above), referring third-party effectiveness and priority to two different laws depending on the identity of the competing claimant would result in all secured creditors seeking to meet the third-party effectiveness requirements of both laws in order to ensure priority against all possible competing claimants. This result is bound to add to the cost and time required for a transaction, even if it related to intellectual property rights protected under the law of a single State. Furthermore, referring priority and enforcement to two different laws could result in inconsistencies as one law would apply to priority in one State and another law could apply to priority in another State in which a priority issue is rather

characterized as an enforcement issue. It should also be noted that referring priority and enforcement to two different laws might create circular priority problems. It is precisely to avoid these problems that the *Guide* recommends the law applicable to enforcement as the law applicable to the priority of a security right in an intangible asset (see recommendation 218).

31. The advantages and disadvantages of the approaches mentioned above (see paras. 7-30 above) may be illustrated with the examples discussed below (see paras. 32-52), dealing separately with creation, third-party effectiveness, priority and enforcement issues.

5. Examples for a comparative analysis of the various approaches

(a) Creation issues

32. Intellectual property owner A, located in State X, owns a portfolio of copyrights in and protected under the laws of State X (in which security rights in copyright are not capable of being registered in an intellectual property registry), and a portfolio of patents and trademarks in and protected under the laws of State Y. Pursuant to a single security agreement, A creates a security right in both portfolios in favour of SC1 located in State Y. A then creates a security right in the same patent and trademark portfolio in favour of SC2 also located in State Y.

33. Under the *lex protectionis* approach (see recommendation 248, option A), A and SC1 would have to meet the creation requirements of State X with respect to the copyright portfolio protected under the law of State X and the requirements of State Y with respect to patent and trademark portfolio protected under the law of State Y. If they fail to do so, the security agreement will achieve only part of its intended purpose; for example, it may create a security right under the law of State X, but fail to create a security right under the law of State Y.

34. Under the first hybrid approach that combines the law of the State of the grantor's location and the *lex protectionis* (see recommendation 248, option B), A and SC1 would need to meet the requirements of State X for the creation of its security right in both the copyright portfolio and the patent and trademark portfolio (that is, for the security right to be effective between grantor A and secured creditor SC1).

35. Under the second hybrid approach that distinguishes between security rights in intellectual property rights that may be registered in an intellectual property registry and those that may not be registered in such a registry (see recommendation 248, option C), creation issues with respect to the security right in the copyright portfolio would still be referred to the law of State X (as the State of the grantor's location, although with respect to the copyright portfolio it is also the protecting State); and creation issues with respect to the security right in the patent and trademark portfolio would be referred to the law of State Y (assuming that rights in patents and trademarks may be registered in specialized registries in that State).

36. Under the third hybrid approach that permits limited party autonomy with respect to the law applicable to the creation of a security right in intellectual property (see recommendation 248, option D), the law of State X (or State Y) would apply, unless the parties chose in the security agreement the law of State Y (or State X). To the extent that both States distinguish between creation and

third-party effectiveness and attribute to creation effects only as between the parties, this approach would not create problems. Otherwise, this approach could result in the application of more than one law to creation issues. It should be noted that, if creation is distinct from third-party effectiveness and is referred by A and SC1 to the law of State X (law of the State of the grantor's location) and by A and SC2 to the law of State Y (the protecting State), no major problem would arise as long as the priority conflict between SC1 and SC2 is referred to one law, in this example, to the law of State Y, the protecting State (see, however, para. 29).

37. When the only difference between the laws of States X and Y with respect to the creation of a security right lies in the fact that, for example, State X, which has not enacted the recommendations of the *Guide* requires more formalities in a security agreement than does State Y, which has enacted the rules recommended in the *Guide*, this difficulty can be overcome by preparing the security agreement so that it satisfies the requirements of the more stringent law (although this could result in additional costs for the transaction). However, when States X and Y have inconsistent requirements with respect to formalities, this approach will not suffice to overcome this problem. Similarly, where the security agreement contemplates multiple present and future intellectual property rights as encumbered assets, difficulties may arise that could not be overcome. This is so in particular when a State has enacted the rules recommended in the *Guide* (allowing a single security agreement to create security rights in multiple present and future assets), while another State does not allow a security agreement to create a security right in assets not yet in existence or not yet owned by the grantor, or does not allow multiple assets to be encumbered in one and the same agreement.

(b) Third-party effectiveness issues

38. In the same example (see para. 32 above), in order to make its security right effective against third parties, under the *lex protectionis* approach (see recommendation 248, option A), SC1 would need to meet the third-party effectiveness requirements of State X to make its security right in the copyright portfolio effective against third parties and the requirements of State Y to make its security right in the patent and trademark portfolio effective against third parties. This would possibly necessitate the registration of multiple notices with respect to the security right in the relevant registries of those States. In addition, potential creditors would have to search in all those registries. This means that potential creditors of A would need search the relevant registry in State X to find the security right in favour of SC1 in the copyright portfolio and the relevant registry in State Y to find the security right in favour of SC1 and SC2 in the patent and trademark portfolio. 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 an intellectual property registry and still other States might utilize an intellectual property registry, if registration in such a registry is mandatory under law relating to intellectual property (see recommendation 4, subpara. (b)). This disadvantage would be alleviated if there were an international registry in which notices of security rights, the third-party effectiveness of which was governed by the law of different States, could be registered.

39. However, under the first hybrid approach (see recommendation 248, option B), it would be sufficient for SC1 to meet the third-party effectiveness requirements of

State X. Any potential creditors of A would need to search only in the relevant registry in State X to find any security right created by A in its copyright portfolio in State X or in its patent and trademark portfolio in State Y (although they may have to search in the patent and trademark registry in State Y, if it permits registration of security rights with third-party effects).

40. Under the second hybrid approach (see recommendation 248, option C), SC1 would need to meet the third-party effectiveness requirements of State X with respect to the security right in the copyright portfolio and the third-party effectiveness of State Y with respect to the security right in the patent and trademark portfolio.

41. Under the third hybrid approach (see recommendation 248, option D), SC1 and SC2 would probably have to meet the third-party effectiveness requirements of both States X and Y to ensure the effectiveness of their security rights against all possible competing claimants.

(c) Priority issues

42. In the same example (see para. 30 above), if A creates another security right in its patent and trademark portfolios protected in State Y in favour of SC2, there will be a priority conflict between the security rights of SC1 and SC2 in the patents and trademarks protected in State Y.

43. Under the *lex protectionis* approach (see recommendation 248, option A), this priority conflict would be governed by the laws of State Y. The law of State Y would govern this priority conflict also under the approach referring priority of a security right in intellectual property that may be registered in an intellectual property registry to the law of the State under whose authority the registry is maintained.

44. Another example will illustrate how the *lex protectionis* approach will apply in the case of multiple transfers in a chain of title, where the transferor and each of the transferees create security rights. A, located in State X, owns a patent in State X. Owner A grants a security right in a patent to secured creditor SC1. A then transfers the patent to B, located in State Y, who creates a security right in favour of SC2. Whether transferee B obtains the patent subject to the security right of SC1 will be determined in accordance with the *lex protectionis*, that is, the law of State X, which happens to be also the law of the grantor's location. Whether secured creditor SC2 takes its security right in the patent from transferee B subject to the security right of SC1 will also be determined in accordance with the *lex protectionis* (normally, under the *nemo dat* principle, SC2 will acquire no more rights than B had).

45. Under the first hybrid approach (see recommendation 248, option B), this priority conflict would be governed by the law of State X, in which the grantor is located. Under the second hybrid approach (see recommendation 248, option C), the law of State Y would apply to the security right in the patent and trademark portfolio (registered in State Y) and the law of State X (the law of the State in which the grantor is located) would apply to the priority of the security right in the copyright portfolio. To slightly modify the example, if the copyright portfolio also includes copyrights protected in various States (in addition to State X) in which registration of a copyright and a security right in a copyright may be possible, the law of all those various States would apply to the priority of a security right in these copyrights.

46. Under the third hybrid approach (see recommendation 248, option D), circular priority problems could arise. If grantor A became insolvent and insolvency proceedings were instituted in State X, under this approach, priority as between SC1 and SC2 would be governed by the law of State Y, while priority as between the insolvency representative (on one hand) and SC1 and SC2 (on the other hand) would be governed by the law of State X. If: (a) under the law of State X, the insolvency representative has priority over SC1 but not over SC2 and (b) under the law of State Y, SC1 has priority over SC2, then: the right of SC1 has priority over the right of SC2 (under the law of State Y), the right of insolvency representative has priority over the right of SC1 (under the law of State X), and the right of SC2 has priority over the right of the insolvency representative (under the law of State X). The result would be circular priority, as the right of SC1 prevails over the right of SC2 whose right prevails over the right of the insolvency representative whose right prevails over the right of SC1.

47. It should be noted that circular priority problems may arise even within one and the same State. However, in the situation described in the preceding paragraph, the circular priority problem arises as a result of referring priority to two different laws. It should also be noted that, at the substantive law level, there are solutions to such circular priority problems. In the example mentioned, one solution could be to provide that the right of SC2 would have priority if under insolvency law the right of SC1 is not recognized as effective against third parties if a notice of it was not registered in State X. Another way to resolve this problem may be the following: the right of SC2 would have priority over the right of the insolvency representative, but would have to turn over the proceeds to SC1, because, as between SC1 and SC2, SC1 would have priority.

(d) Enforcement issues

48. In the same example (see para. 32 above), if A does business in States X, Y and Z and uses a particular patent under the law of each of those States, those patent rights may well have greater value taken together than they do separately because they operate collectively. Thus, if A creates a security right in those patents, 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 intellectual property rights. If State X allows only a judicial disposition of an encumbered asset, while States Y and Z allow a non-judicial disposition, disposition of the patent rights in a single transaction might be impossible. Even if all of the relevant States allow non-judicial disposition, the differences in required procedures may make a disposition of the rights in a single transaction inefficient at best.

49. Moreover, enforcement of a security right is not a single event; rather it is a series of actions. So, upon A's default, SC1, located in State Y, may notify A, located in State X, that it will enforce its security right in its patent rights protected under the laws of States X, Y and Z. SC1 may then advertise the disposition of the patent right in States X, Y and Z; indeed, it may advertise the disposition worldwide by means of the Internet. 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.

50. Under an approach based on the *lex protectionis* or the law of the State under whose authority the registry is maintained (see recommendation 248, options A and C), SC1 would need to enforce its security right in the patent protected in State X in accordance with the law of State X, its security right in the patent protected in State Y in accordance with the law of State Y and its security right in the patent protected in State Z in accordance with the law of State Z. Under the first hybrid approach (see recommendation 248, option B), enforcement of the security right in the patent would be governed by the law of the State in which grantor A is located. It should be noted that, no matter which approach is followed, if SC1 sells the encumbered patent, in order to be fully protected, the transferee will have to register its rights in the patent registry of each State in which the patent is registered and protected, that is, States X, Y and Z.

51. It should also be note that, where A, located in State X, creates a security right in a patent registered in the national patent office in State Y and then 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 an approach based on the law of the grantor's location or an approach based on the *lex protectionis* is followed in the forum. Under the law recommended in 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.

52. Under the third hybrid approach (see recommendation 248, option D), problems could arise if enforcement and priority are referred to different laws. For example, if enforcement is referred by A and SC1 to the law of State X (the law of the State of the grantor's location) and by A and SC2 to the law of State Y (the protecting State), the grantor became insolvent and SC1 and SC2 competed with the insolvency representative, one law, that is, the law of the State of the grantor's location would apply, except if the insolvency representative were treated as an owner, in which case the *lex protectionis* would apply. In addition, having the laws of States X and Y apply to priority and enforcement issues may result in two laws applying to the same issue because in State X it may be characterized as a priority issue while in State Y it may be characterized as an enforcement issue. Moreover, having the laws of States X and Y apply to procedural enforcement issues (for example, time periods for notices or which of the two enforcing secured creditors had priority and could take over enforcement, distribution of proceeds) could result in uncertainty and inconsistencies. This would be particularly problematic if the law of State X allowed an extra-judicial sale of the encumbered asset while the law of State Y prohibited it (and which one of the two secured creditors sold the asset may have an impact on whether the transferees acquired the encumbered asset free or subject to the security right).

B. Law applicable to contractual matters

53. Under the law recommended in the *Guide*, the law applicable to the mutual rights and obligations of the grantor and the secured creditor arising from the security agreement (the contractual aspects of the security agreement) is left to party autonomy. In the absence of a choice of law by the parties, the law applicable to these matters is the law governing the security agreement as determined by the conflict-of-laws rules generally applicable to contractual obligations (see the *Guide*, chap. X, para. 61, and recommendation 216).

54. In view of the wide acceptability of the application of the principle of party autonomy to contractual matters,[5] the same rule should apply to the mutual rights and obligations of the grantor and the secured creditor in the case of a security right in intellectual property.

Recommendation 248[6]

Law applicable to a security right in intellectual property

Option A

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

Option B

248. The law should provide that the law applicable to the creation, effectiveness against third parties, 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 the effectiveness against third parties and priority of a security right in intellectual property as against the right of a transferee or licensee of the encumbered intellectual property is the law of the State in which the intellectual property is protected.

Option C

248. The law should provide that:

(a) Where the intellectual property may be registered in a specialized registry, the law applicable to the creation, effectiveness against third parties and priority of a security right in intellectual property is the law of the State under whose authority the registry is maintained. However, the law applicable to the enforcement of such a security right is the law of the State in which the grantor is located; and

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5 See www.hcch.net/upload/wop/genaff_concl09e.pdf on the development of a future instrument on the choice of law in international contracts by the Hague Conference on Private International Law.

6 If it could be included in the *Guide*, this recommendation would be placed in chapter X, Conflict of laws, as recommendation 214 bis.

(b) Where the intellectual property may not be registered in a specialized registry, 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 effectiveness against third parties and priority of such a security right is the law of the State in which the intellectual property is protected.

Option D

248. The law should provide that:

(a) The law applicable to the creation and enforcement of a security right in intellectual property is the law of the State in which [the intellectual property is protected] [the grantor is located], except to the extent that the security agreement provides that these matters are to be governed by the law of the State in which [the grantor is located] [the intellectual property is protected];

(b) The law applicable to the effectiveness against third parties and priority of a security right in intellectual property as against the rights of a transferee, licensee or another secured creditor is the law of the State in which the intellectual property is protected; and

(c) The law applicable to the effectiveness against third parties and priority of a security right in intellectual property as against all other competing claimants is the law of the State in which the grantor is located.

[*Note to the Commission: The Commission may wish to consider adopting the* lex protectionis *approach (option A), the first hybrid approach (option B) or both for States to choose from. In that regard, the Commission may wish to note that, even if it adopted option B, the* lex protectionis *could still apply in the following situations: (a) as provided in option B; and (b) even to matters beyond those mentioned in option B, in accordance with recommendation 4, subparagraph (b). In essence, under option B, it would be left to secured creditors to determine whether to meet the third-party effectiveness requirements of the law of the grantor's location (if they wanted to protect themselves essentially against the insolvency representative) or the* lex protectionis *(if they wanted to protect themselves against all possible competing claimants).*

The Commission may also wish to consider that, while all options have advantages and disadvantages and no option is perfect, any positive elements of the hybrid approaches in options C and D, are either already covered by or may be covered in options A and B, without multiplying the options and creating an additional level of complexity, which may undermine the certainty and predictability sought to be achieved by a conflict-of-laws rule.

More specifically, to the extent that options A and B refer to the lex protectionis, *whether directly or indirectly through recommendation 4, subparagraph (b), they both sufficiently address any registration requirements under national, regional or international law. In addition, the second subparagraph of option C essentially reflects option B. Moreover, the application of the rule in subparagraph (a) of option C would depend on whether intellectual property registration regimes permit the registration of a security right in intellectual property with third-party effects (which is currently the exception rather than the rule). Finally, option C has a number of other disadvantages (see paras. 26 and 27 above). As to option D, the*

Commission may wish to consider that referring third-party effectiveness and priority to one law and enforcement to another law may create serious problems (see paras. 30, 46 and 52 above). In addition, if option D were revised to ensure that third-party effectiveness, priority and enforcement would be referred to the same law, as option B addresses in the same way matters addressed in subparagraphs (b) and (c) of option D, the only difference between options B and D would be the party autonomy permitted by option D with respect to creation.

If the Commission wishes to retain some reference to party autonomy with respect to the creation of a security right in intellectual property, the Commission may wish to consider adding a reference to party autonomy in option A (or B), preserving any specialized registration requirements. Language along the following lines could be considered with respect to option A: "However, the grantor and the secured creditor may agree that the law applicable to the creation of a security right in intellectual property is the law of the State in which the grantor is located, except if the security right in intellectual property may be registered in an intellectual property registry, in which case the law applicable to the creation of the security right is the law of the State under whose authority the registry is maintained." In option B, similar language may need to be inserted to limit its application to security rights that are not capable of being registered in an intellectual property registry of the State in which the intellectual property is protected.

Irrespective of the approach taken to the law applicable to security rights in intellectual property, the Commission may wish to consider adding in the commentary a reference to a so-called "accommodation rule" followed in some States with a view to enhancing the cross-border recognition of security rights in cases where they would not be recognized in the forum, whose law would be applicable. Under such a rule, if the forum, whose law is applicable, does not recognize, for example, an assignment of a copyright made under a foreign law, the assignment of a copyright under the foreign law may still be "salvaged" and recognized in the forum as an exclusive licence, which is recognized in the forum. Similarly, if a non-possessory security right is not effective in the forum, whose law is applicable, the non-possessory security right may still be "salvaged" in the forum and recognized as a transfer for security purposes, which is a device known in the forum. This is not an asset-specific issue, but it could arise in an intellectual property context and, in view of the prevalence of the lex protectionis*, enhance the cross-border recognition of security rights in intellectual property created under a law other than the* lex protectionis.

In addressing these matters, the Commission may finally wish to take into account the work of other organizations, such as the European Max-Planck-Group for Conflict of Laws in Intellectual Property (CLIP) on Principles for Conflict of Laws in Intellectual Property (http://www.cl-ip.eu/).]

XI. Transition

55. Under the law recommended in the *Guide*, the law should set out the date as of which it will come into force (the "effective date") and specify the extent to which, after the effective date, the new law applies to security rights that existed before the effective date (see the *Guide*, chap. XI, paras. 1-3 and recommendation 228).

56. The different approaches to establishing an effective date as set out in the *Guide* offer States different possibilities for doing so. Whichever is selected, however, will provide a clear mechanism for determining when the law or its various parts will come into force (see the *Guide*, chap. XI, paras. 4-6). Neither the *Guide* nor the draft Supplement recommends that the effective date of the provisions of the law relating to security rights in intellectual property be different from the effective date of other provisions of the law. Thus, the approaches discussed in chapter XI of the *Guide* can be applied without modification to determine the date at which the provisions with respect to security rights in intellectual property will come into force. The only additional considerations are the following: (a) the entire law recommended in the *Guide* must come into force either at the time or before the provisions relating to security rights in intellectual property come into force; and (b) the provisions with respect to intellectual property rights must come into force as a whole. In other words, States may defer the coming into force of the provisions relating to security rights in intellectual property until a date after the general law has come into force, but when they decide to proclaim in force the provisions relating to security on intellectual property, they must do so in a manner that ensures that all these provisions come into force at the same time.

57. The *Guide* also contains recommendations relating to the protection of rights acquired before the effective date of the new law. The general principle is that the new law applies even to security rights that exist at the effective date. Consequently, if registration of a notice of a security right in the general security rights registry or in the relevant intellectual property registry becomes newly possible, States will have to provide for a grace period to enable notices of these security rights to be registered (thereby protecting both third-party effectiveness and priority as it existed under prior law). This principle and its implications are elaborated upon in the *Guide* (see chap. XI, paras. 20-26).

58. A particular transition issue arises in relation to enforcement, that is, whether enforcement proceedings that had commenced prior to the effective date of the new law would have to be abandoned and recommenced under the new law. To avoid this result, the law recommended in the *Guide* provides that, once enforcement proceedings have been commenced in a court or binding arbitral tribunal, they may continue under prior law. However, it is possible for the enforcing secured creditor to abandon proceedings under prior law and recommence enforcement under the new law, in particular if the new law recommended in the *Guide* provides secured creditors with remedies not available under prior law (see chap. XI, paras. 27-33). This principle should be equally applicable to enforcement proceedings commenced in respect of security rights in intellectual property.

59. Because the recommendations of the *Guide* relating to security rights in intellectual property offer financing and transactional opportunities that have not heretofore existed in many States, it might be thought that special provisions to govern transition to the new law would be required. The above review suggests, however, that the basic transition principles set out in the law recommended in the *Guide* can be applied without modification to the regime of security rights in intellectual property as recommended in the draft Supplement. No additional recommendations are needed for this purpose.

XII. 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 Commission: For paras. 56-78, see A/CN.9/WG.VI/WP.42/Add.6; A/CN.9/689, para. 58; A/CN.9/WG.VI/WP.38/Add.7, paras. 24-42; A/CN.9/685, para. 95; A/CN.9/WG.V/WP.87; A/CN.9/WG.VI/WP.37/Add.4, paras. 22-40; A/CN.9/671, paras. 125-127; A/CN.9/670, paras. 116-122; A/CN.9/WG.VI/WP.35/Add.1, chapter XI; A/CN.9/667, paras. 129-140; A/CN.9/WG.VI/WP.33/Add.1, paras. 58-72; A/CN.9/649, paras. 98-103; and A/63/17, para. 326.*]

A. General

60. 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 licence 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 or exploit the licensed intellectual property 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 recommendation 29).

61. Insolvency law, subject to avoidance actions, will typically respect the effectiveness of such a security right (see the *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 recommendations 238 and 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. For example, an insolvency of a party in the middle of the chain will affect the licence of subsequent sub-licensees and sub-licensors, but will not have any legal effect on previous ones. The terms of a licence agreement may provide for different results (for example, automatic termination of all licences upon the insolvency of any licensee up or down in the chain from the insolvent licensee), but these results will be subject to limitations under insolvency law (for example, rendering unenforceable automatic termination clauses).

62. 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 the payment of royalties. Secured transactions law will typically not affect statutory limitations, other than mainly those relating to a future receivable, or a receivable assigned in bulk or in part on the sole ground that it is a future receivable, or a receivable assigned in bulk or in part (see recommendation 23).

Secured transactions law may affect contractual limitations (see recommendations 18, 24 and 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 the *Insolvency Guide*, recommendations 83-85).

63. 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 the *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 has not been 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 or exploit the licensed intellectual property in line with the terms and conditions of the licence agreement) or the licensee (owing payment of royalties and the obligation to use or exploit the licensed intellectual property in accordance with the licence agreement).

64. The *Insolvency Guide* recommends that any contractual clauses that automatically terminate and accelerate a contract upon an application for commencement, or commencement, of insolvency proceedings or upon the appointment of an insolvency representative should be unenforceable as against the insolvency representative and the debtor (see the *Insolvency Guide*, recommendation 70). The *Insolvency Guide* also recommends that the insolvency law should specify the contracts that are exempt from the operation of this recommendation, such as financial contracts, or are subject to special rules, such as labour contracts (see the *Insolvency Guide*, recommendation 71).

65. The commentary of the *Insolvency Guide* states that some laws uphold these clauses in some circumstances and explains the reasons for this approach. These reasons include the need for creators of intellectual property to be able to control the use of that property and the effect on a counterparty's business of termination of a contract, especially one with respect to an intangible (see part two, chap. II, para. 115, of the *Insolvency Guide*). For example, automatic termination and acceleration clauses contained in intellectual property licence agreements may be upheld as the insolvency of the licensee may have a negative impact not only on the licensor's rights but also on the intellectual property right itself. This is the case, for example, where the insolvency of a licensee of a trademark used on products may affect the market value of the trademark and the trademarked products. In any case, clauses included in intellectual property licence agreements that provide, for example, that a licence terminates after X years or upon material breach such as failure of the licensee to upgrade or market the licensed products on time (that is, where the event that triggers the automatic termination is not insolvency) are not affected (see the *Insolvency Guide*, footnote 39 to recommendation 72).

66. The commentary of the *Insolvency Guide* also states that other laws override these clauses and explains the relevant reasons (see part two, chap. II, paras. 116 and 117). The commentary further explains that, although some insolvency laws do permit these types of clause to be overridden if insolvency proceedings are

commenced, this approach has not yet become a general feature of insolvency laws. In this regard, the commentary speaks of an inherent tension between promoting the debtor's survival, which may require the preservation of contracts, and affecting commercial dealings by creating a variety of exceptions to general contract rules. The commentary concludes by expressing the desirability that an insolvency law permit such clauses to be overridden (see part two, chap. II, para. 118).

67. 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 the *Insolvency Guide*, recommendations 72 and 73). In the case of 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 of a licence agreement 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 of a licence agreement will affect each party both in its capacity as licensor and licensee.

68. If the insolvency representative chooses to continue a licence agreement that 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 the *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, see part two, chap. II, sect. E, of the *Insolvency Guide*).

B. Insolvency of the licensor

69. 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.

70. 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 (that is, the licensee's authority to use or exploit the licensed intellectual property).

71. 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. Such a secured creditor may, for example, protect itself by obtaining and making effective against third parties (in addition to a security right in the licensor's rights under the licence agreement, that is, 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 a security right 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). 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. As a practical matter, however, this arrangement would be worthwhile only for significant licence agreements.

72. 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 too would be worthwhile only for significant licence agreements.

73. As already mentioned, if at least one party has fully performed its obligations with respect to a licence agreement, the licence 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 licence agreement, however, the licence 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.

74. For example, some States give a licensee the right to continue to use or exploit 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 terms and conditions of the licence agreement, 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.

75. 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 of contracts 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; or (d) they are registered in the relevant intellectual property registry. In these States, the licensee may be able to retain the licence as long as it pays the royalties owed under the licence agreement.

76. 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 or exploit 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.

77. It should be noted that the *Insolvency Guide* provides (part two, chap. II, para. 143) that exceptions to the power to reject may also be appropriate in the case of labour agreements, agreements where the debtor is a lessor or franchisor or a licensor of intellectual property and termination of the agreement would end or seriously affect the business of the counterparty, in particular where the advantage to the debtor may be relatively minor, and contracts with government, such as licensing agreements and procurement contracts. 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 may 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. States may also wish to consider to what extent the commercial practices described in paragraphs 71 and 72 above would provide adequate practical solutions.

C. Insolvency of the licensee

78. 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 or exploit the licensed intellectual property (in accordance with the terms and conditions of 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 the payment of royalties under the licence agreement, the licensor's secured creditor will continue to have a security right in the licensor's right to the payment of royalties.

79. 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 or exploit 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 the payment of royalties under the licence agreement, the licensor will lose its right to the payment of royalties and its secured creditor will lose its encumbered asset.

80. 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. 71 and 72 above).

81. 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 that the licensor 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. 68 above), are essential. In addition, in situations where the insolvent licensee had granted a security right in its rights to the payment of 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 sub-royalties and the licensee does not have another source for payment of royalties to the licensor, it is essential that the licensor have a right to terminate the licence to protect its rights.

D. Summary

82. The following table summarizes the impact of the insolvency of a licensor or licensee on a security right in that party's rights under a licence agreement.

	Licensor is insolvent	*Licensee is insolvent*
Licensor grants a security right in its rights under a licence agreement (primarily the right to receive royalties)	Question: What happens if the licensor or its insolvency representative decides to continue the performance of the licence agreement under the insolvency law (see the *Insolvency Guide*, recommendations 69-86)?	Question: What happens if the licensee or its insolvency representative decides to continue the performance of the licence agreement under the insolvency law (see the *Insolvency Guide*, recommendations 69-86)?
	Answer: The licensee continues to owe royalties under the licence agreement and the secured creditor of the licensor continues to have a security right both in the licensor's right to royalties under the licence agreement and in the proceeds of that right, in other words, any royalty payments that are made.	Answer: The licensor continues to have a right to receive royalties under the licence agreement 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 agreement 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 representative rejects the licence agreement under the insolvency law (see the *Insolvency Guide*, recommendations 69-86)?	Question: What happens if the licensee or its insolvency representative rejects the licence agreement under the insolvency law (see the *Insolvency Guide*, recommendations 69-86)?
	Answer: The licensee does not owe royalties under the licence agreement 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 agreement.	Answer: The licensee does not continue to owe royalties under the licence agreement 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 agreement.

	Licensor is insolvent	*Licensee is insolvent*
Licensee grants a security right in its rights under a licence agreement (primarily the right to use the intellectual property)	Question: What happens if the licensor decides to continue the performance of the licence agreement under the insolvency law (see the *Insolvency Guide*, recommendations 69-86)? Answer: The licensee continues to have rights under the licence agreement and the secured creditor of the licensee continues to have a security right in those rights under the licence agreement. Question: What happens if the licensor or its insolvency representative rejects the licence agreement under the insolvency law (see the *Insolvency Guide*, recommendations 69-86)? Answer: The licensee does not have rights under the licence agreement 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.	Question: What happens if the licensee decides to continue the performance of the licence agreement under the insolvency law (see the *Insolvency Guide*, recommendations 69-86)? Answer: The licensee continues to have rights under the licence agreement and the secured creditor of the licensee continues to have a security right in those rights under the licence agreement. Question: What happens if the licensee or its insolvency representative rejects the licence agreement under the insolvency law (see the *Insolvency Guide*, recommendations 69-86)? Answer: The licensee does not have rights under the licence agreement 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.