United Nations

A/CN.9/WG.VI/WP.42/Add.6

General Assembly

Distr.: Limited
2 December 2009

Original: English

United Nations Commission on International Trade Law
Working Group VI (Security Interests)
Seventeenth session
New York, 8-12 February 2010

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

Note by the Secretariat

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V.09-88580 (E)

X. Law applicable to a security right in intellectual property

[*Note to the Working Group: For paras. 1-46, see 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 chapter X on conflict of laws, paras. 1-9 of the *Guide*).

2. The conflict-of-laws chapter of the *Guide* does not define the security rights to which the conflict-of-laws rules 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 recommendations of the *Guide* following a non-unitary approach to acquisition financing should apply the conflict-of laws provisions governing security rights to retention-of-title rights or financial leases (see recommendation 201). Similarly, (as the term security right includes the right of an outright assignee of receivables; see the term "security right", Introduction to the Guide, section B on terminology and interpretation), the *Guide* recommends that such a State should apply the conflict-of-laws provisions governing security assignments of receivables to outright assignments of receivables (see recommendation 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 recommendations of the *Guide* have been prepared to reflect the substantive law recommendations of the *Guide*, a State that enacts both the substantive law and the conflict-of-laws recommendations of the *Guide* will have no difficulty in applying either. If, however, a State does not enact the substantive law recommendations of the *Guide*, it may find it difficult to apply the conflict-of-laws recommendations of the *Guide*. This may be so to the extent that that State treats creation and third-party effectiveness as one issue, while the conflicts-of-laws recommendations in the *Guide* treat them as two separate issues and refer them to the laws of different States. This difficulty will not arise, however, with regard to the distinction between the creation of a security right in an intangible asset (referred to the law of the grantor's location; see recommendation 208) and the mutual rights and obligations of the parties (referred to the law chosen by them; see recommendation 216). This is so, because the *Guide* follows the approach followed in most States, drawing a distinction between property rights

(referred to a specific law) and contractual rights (typically referred to the law chosen by the parties).

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 recommendations of the *Guide*. Thus, to the extent that conflict-of-laws rules outside those recommended in the *Guide* refer issues of transferability of intellectual property rights to the law of the State in which the intellectual property is protected (*lex loci protectionis*; hereinafter referred to as the "*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 provisions recommended in the *Guide* do not override statutory limitations to transferability (see recommendation 18).

5. When the conflict of laws rules of the law 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, including not only statutory and non-statutory law (see 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 as a result of 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.

6. Finally, it should be noted that, like all the other provisions of the law recommended in the *Guide*, the conflict-of-laws provisions 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, subparagraph (b)).

2. The approach recommended in the *Guide*

7. In many States, the conflict-of-laws rules that apply to security rights in intangible assets apply also to security rights in intellectual property. Similarly, the conflict-of-laws rules recommended in the *Guide* with respect to security rights in intangible assets would also apply to security rights in intellectual property, if no asset-specific rule is provided for intellectual property. Thus, if a State enacts the conflict-of-laws recommendations of the *Guide*, making them applicable to security rights in intellectual property without any change, 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 (see recommendations 208, and 218, subparagraph (b)). The location of the grantor is defined as its place of central administration, that is, the real rather than the statutory seat, of the grantor (see recommendation 219). Recommendation 4, subparagraph (b), would also apply and, to the extent of any inconsistency between the conflict-of-laws rules recommended in the *Guide* and those of the law relating to intellectual property that applied specifically to intellectual property, defer to any conflict-of-laws rule of the law relating to intellectual property.

8. The principal advantage of an approach based on the law of the grantor's location 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 would in most cases be reduced, as a secured creditor would need to register and a searcher would need to search only in the State in which the grantor is located. This would reduce transaction costs and enhance certainty, a result that is likely to have a beneficial impact on the availability and the cost of credit.

9. Another particularly important advantage of an approach based on the law of the grantor's location results from the meaning attributed in the *Guide* to the term "location" in cases where the grantor has a place of business in more than one State (see recommendation 219). In this case, "location" refers to the State in which the grantor has its place of central administration (that is, its real, rather than its statutory, seat). This is also the law of the State in which the main insolvency proceedings with respect to the grantor are likely to be administered (as to the meaning of a main proceeding, see, for example, articles 2, subparagraph (b), and 16, paragraph 3 of the UNCITRAL Model Law on Cross-Border Insolvency). As a result, the law governing the creation, third-party effectiveness, priority and enforcement of a security right and the law governing, 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 would result to a conflict of the law of the statutory seat with the law of the State in which insolvency proceedings will be opened (*lex fori concursus*), a conflict which is likely to be resolved in favour of the application of the *lex fori concursus*.

10. However, the approach based on the law of the grantor's location has also disadvantages. For example, if the grantor is not the initial owner of the encumbered asset but a transferee that has not taken the asset free of a security right or other right created by the initial or intermediate owner, a potential secured creditor would need to conduct a search outside the security rights registry to determine the chain of transferees. The potential secured creditor would then need to conduct another search in the security rights registry (and possibly in the relevant intellectual property registry, if any) to determine if the initial or intermediate owner has created a security right in the same intellectual property. In addition, if the initial or intermediate owner is 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. Moreover, a conflict-of-laws rule based on the grantor's location would nevertheless require a reference to the *lex protectionis* for certain issues. In particular, as the *lex protectionis* is typically the law governing ownership in intellectual property, a priority conflict between a security right in intellectual property and the ownership right of an outright transferee of the encumbered intellectual property would have to be governed by the *lex protectionis*, at least insofar as determination of the rights of the putative transferee is concerned.

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

11. 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 in another State) is the *lex protectionis*.

12. The view is expressed[1] 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(1) of the Paris Industrial Property Convention or Article 5(2) of the Berne Intellectual Property Convention leave no room for a connecting factor other than the place of protection of the relevant intellectual property right. In other words, under this view, States parties to any of these international conventions cannot freely determine their conflict-of-law rules and no law other than the *lex protectionis* could be applied to issues arising with respect to security rights in intellectual property.

13. 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 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.

14. However, there are also disadvantages to an approach based on the *lex protectionis* as the applicable law for security rights, especially in transactions in which a portfolio of intellectual property rights is used as security for credit or transactions in which the encumbered assets are not limited to intellectual property that is used and protected under the law of a single State.

4. Other approaches

15. The view mentioned above (see paras. 12-13 above), attributing such an extensive effect to international intellectual property conventions with respect to the issue 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 a given conflict-of-laws rule, it would still be questionable whether the scope of application of this rule would cover all property effects contemplated by the draft Supplement, that is, the creation, effectiveness against third parties,

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

priority as against the rights of competing claimants and enforcement of a security right in intellectual property.

16. Accordingly, even if one accepts the extensive effect of international intellectual property conventions described in paragraphs 12-13 above, it would still be necessary or useful to formulate a recommendation on the law applicable to issues arising with respect to security rights in intellectual property. Such a recommendation 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.

17. 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*.

18. For example, issues arising with respect to a security right in intellectual property that is subject to registration in an intellectual property registry 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). 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. This combination of the two approaches might, however, 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 is not subject to a prior security right.

19. Other combinations of the two approaches might also be possible. 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* (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).

20. The advantages and disadvantages of the approaches mentioned above (see paras. 7-20 above) may be illustrated with the examples discussed below (see paras. 21-35), dealing separately with creation, third-party effectiveness, priority and enforcement issues.

5. Examples for a comparative analysis of the various approaches

(a) Creation issues

21. Intellectual property owner A, located in State X, creates pursuant to a single security agreement with secured creditor SC1, located in State Y, a security right in a copyright portfolio, protected under the laws of State X, and in a patent and trademark portfolio, protected under the laws of State Y.

22. Under the law of the grantor's location approach, A and SC1 would need to meet the requirements of State X for the creation of its security right in all intellectual property rights (that is, for the security right to be effective between grantor A and secured creditor SC1).

23. Under the *lex protectionis* approach, 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, that is, create a security right under the law of State X, but fail to create a security right under the law of State Y.

24. Under the 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, creation issues with respect to the security right in the copyright portfolio would be referred to the law of State X (assuming that copyrights may not be registered in a specialized registry); 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).

25. 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 that has not enacted the recommendations of the *Guide* requires more formalities in a security agreement than does State Y that has enacted the recommendations of the *Guide*, this difficulty can be overcome by preparing the security agreement so that it satisfies the requirements of the most stringent law (although even that will create 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 agreement contemplates multiple present and future intellectual property rights as encumbered assets, difficulties cannot be overcome. This is so in particular when a State has enacted the recommendations of 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. It should finally be noted that, as creation of a security right means that it is effective between the grantor and the secured creditor (and not as against third parties), the policy that underlies the *lex protectionis* does not appear to dictate referring the creation of a security right to that law.

(b) Third-party effectiveness issues

26. In order to make its security right effective against third parties, under the law of the grantor's location approach, it would be sufficient for secured creditor SC1 to meet the third-party effectiveness requirements of State X. Any potential creditors of intellectual property owner A would need to search only in the relevant registry in State X.

27. Under the *lex protectionis* approach, however, secured creditor 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 in 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; and potential creditors would have to search in all those registries. This situation could be further complicated by the fact that some of those States might utilize the general security rights registry for such notices, other States might provide the option of utilizing a specialized registry, and still other States, might utilize an intellectual property registry that is mandatory under recommendation 4, subparagraph (b). This disadvantage would be alleviated if there were an international registry in which notices with respect to security rights, the third-party effectiveness of which is governed by the law of different States, could be registered.

28. Under the approach that distinguishes between security rights in intellectual property that may be registered in an intellectual property registry and security rights in intellectual property that may not be so registered, 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 respect to the security right in the patent and trademark portfolio.

(c) Priority issues

29. If intellectual property owner A creates another security right in its patent and trademark portfolios protected in State Y in favour of secured creditor SC2, there will be a priority conflict between the security rights of SC1 and SC2 in the patents and trademarks protected in State Y.

30. Under the law of the grantor's location approach, this priority conflict would be governed by the law of State X in which the grantor is located. Under the *lex protectionis* approach, however, 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.

31. Another example will illustrate how the *lex protectionis* 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 the 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).

(d) Enforcement issues

32. If intellectual property owner A does business in States X, Y and Z and uses a particular trademark under the law of each of those States, those trademark rights may well have greater value taken together than they do separately because they operate collectively. Thus, if A grants a security right in those trademarks, secured creditor SC1 would likely prefer to dispose of them together upon A's default because such a disposition would likely yield greater proceeds (thus also benefitting A). Yet, this is likely to be difficult or impossible if States X, Y and Z have different rules for disposition of encumbered 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 trademark 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.

33. Moreover, enforcement of a security right is not a single event; rather it is a series of actions. So, upon A's default, secured creditor SC1, located in State Y, may notify A, located in State X, that it will enforce its security right in its trademark rights protected under the laws of States X, Y and Z. Secured creditor SC1 may then advertise the disposition of the trademark right in States X, Y and Z; indeed, it may advertise the disposition worldwide by use of the Internet. Secured creditor SC1 may then identify a buyer located in State Z, who buys the encumbered asset pursuant to a contract governed by the laws of State X.

34. Under an approach based on the *lex protectionis* (or the law of the State under whose authority the registry is maintained), secured creditor SC1 would need to enforce its security right in the trademark protected in State X in accordance with the law of State X, its security right in the trademark protected in State Y in accordance with the law of State Y and its security right in the trademark protected in State Z in accordance with the law of State Z. Under the law of the grantor's location approach, enforcement of the security right in the trademark 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 secured creditor SC1 sells the encumbered trademarks, the transferee has to register its rights in the trademark registry of each State in which the trademark is registered and protected, that is, States X, Y and Z.

35. Where grantor A, located in State X, creates a security right in a patent registered in the national patent office in State Y and then grantor A becomes insolvent, the law applicable to the creation, third-party effectiveness, priority and enforcement of the security right will be the law of State X or Y, depending on whether an approach based on the law of the grantor's location or an approach based on the *lex protectionis* is followed in the forum State. 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.

(e) Change of location of the grantor or the encumbered asset and relevant time for determining location

36. It should be noted that where the grantor or the encumbered asset moves from one State to another State that has enacted the recommendations of the *Guide*, different rules apply. According to these rules, if the grantor or the encumbered asset (whichever determines the applicable law under the relevant conflict-of-laws provisions) moves to a State that has enacted the recommendations of 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 then only if the third-party effectiveness requirements of the State of the new location are met (see recommendation 45).

37. For example, grantor A, located in State X, creates a security right in favour of secured creditor SC1 in a copyright protected in States X and Y, and then A moves to State Y that has enacted the recommendations of the *Guide* and creates another security in the copyright in favour of secured creditor SC2 in State Y. If State Y has enacted the recommendations of the *Guide*, 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 then 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, as mentioned above (see para. 31 above), whether transferee B obtains the copyright subject to the security right of secured creditor 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*.

38. 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 priority issues the time the issue arises (see recommendation 220). As a result, under the law recommended in the *Guide*, the creation of the security right of SC1 would be subject to 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 grace period (see recommendation 45), be subject to the law of State Y.

B. Law applicable to contractual matters

39. 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 chapter X of the *Guide*, para. 61 and recommendation 216).

40. In view of the wide acceptability of the application of the principle of party autonomy to contractual matters,[2] 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 253[3]

Law applicable to a security right in intellectual property

Alternative A

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.

Alternative B

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 that may be registered in an intellectual property registry is the law of the State under whose authority the registry is maintained. The law applicable to those matters with respect to a security right in intellectual property that may not be registered in an intellectual property registry is the law of the State in which the grantor is located.

Alternative C

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.

XI. Transition

41. Under the recommendations of 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 chapter XI on transition, paras. 1-3).

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[2] See http://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.

[3] If this recommendation could be included in the *Guide*, it would be placed in chapter X on conflict of laws as recommendation 214 bis.

42. 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 (chapter XI on transition, 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 should be different than 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.

43. 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 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 in the *Guide* (see chapter XI on transition, paras. 20-26).

44. 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 chapter XI on transition, paras. 27-33). This principle should be equally applicable to enforcement proceedings commenced in respect of security rights in intellectual property.

45. 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 Working Group: For paras. 46-54, see A/CN.9/WG.VI/WP.37/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, para. 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

46. 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).

47. Insolvency law, subject to avoidance actions, will typically respect the effectiveness of such a security right (see recommendation 88 of the Insolvency Guide). 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 238-239). 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).

48. 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 and 24-25). 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 recommendations 83-85 of the Insolvency Guide).

49. 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 recommendations 69-86 of the Insolvency Guide). 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).

50. 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 recommendation 70 of the Insolvency Guide). 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 recommendation 71 of the Insolvency Guide).

51. 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, chapter 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 footnote 39, recommendation 72 of the Insolvency Guide).

52. The commentary of the Insolvency Guide also states that other laws override these clauses and explains the relevant reasons (see part two, chapter II, paras. 116 and 117 of the Insolvency Guide). 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, chapter II, para. 118 of the Insolvency Guide).

53. 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 recommendations 72-73 of the Insolvency Guide). 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.

54. If the insolvency representative chooses to continue a licence agreement, which has not been fully performed by both parties and as to which the insolvent debtor (licensor or licensee) is in breach, the breach must be cured, the non-breaching counterparty must be substantially returned to the economic position that it was in before the breach, and the insolvency representative must be able to perform the licence agreement (see recommendation 79 of the Insolvency Guide). 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, chapter II, section E of the Insolvency Guide).

B. Insolvency of the licensor

55. 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.

56. 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).

57. 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.

58. 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.

59. 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.

60. 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.

61. 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; (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.

62. 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.

63. It should be noted that the Insolvency Guide provides 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" (see Insolvency Guide, part two, chapter II, paragraph 143). 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 30 and 31 above would provide adequate practical solutions.

C. Insolvency of the licensee

64. 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.

65. 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 royalty stream and its secured creditor will lose its encumbered asset.

66. 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. 32-33 above).

67. 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. 29 above), are essential. In addition, in situations where the insolvent licensee has granted a security right in its rights to receive sub-royalties, those sub-royalties will likely be a source of funds for the licensee to pay the royalties that it owes to the licensor. If the licensee's secured creditor claims all the royalties and the licensee does not have another source for payment of royalties to the licensor, it is essential that the licensor has a right to terminate the license to protect its rights.

Appendix

The following text briefly describes the impact of the insolvency of a licensor or licensee on a security right that party's in 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 recommendations 69-86 of the *UNCITRAL Legislative Guide on Insolvency Law*)?[a]	Question: What happens if the licensee or its insolvency representative decides to continue the performance of the licence agreement under the insolvency law (see recommendations 69-86 of the *UNCITRAL Legislative Guide on Insolvency Law*)?
	Answer: The licensee continues to owe royalties under the licence 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 paid.	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 recommendations 69-86 of the *UNCITRAL Legislative Guide on Insolvency Law*)?	Question: What happens if the licensee or its insolvency representative rejects the licence agreement under the insolvency law (see recommendations 69-86 of the *UNCITRAL Legislative Guide on Insolvency Law*)?
	Answer: The licensee does not owe royalties under the licence 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 recommendations 69-86 of the *UNCITRAL Legislative Guide on Insolvency Law*)? 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 recommendations 69-86 of the *UNCITRAL Legislative Guide on Insolvency Law*)? 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 recommendations 69-86 of the *UNCITRAL Legislative Guide on Insolvency Law*)? 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 recommendations 69-86 of the *UNCITRAL Legislative Guide on Insolvency Law*)? Answer: The licensee does not have rights under the licence agreement with respect to periods after rejection, but retains rights it may still have with respect to periods before rejection; the secured creditor of the licensee continues to have a security right in those rights of the licensee with respect to periods before rejection.

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