# Leveraging Knowledge Assets

**Norman Siebrasse & Catherine Walsh**

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[1] Faculty of Law, University of New Brunswick

[2] Faculty of Law, McGill University

# 1 Introduction

## 1.1 **Purpose of this Report**

Secured credit is a well known and deep-rooted phenomenon. The idea is an intuitively simple one. A debtor grants to its creditor the right, should the debtor default on its loan or credit obligation, to repay itself by appropriating the value of the property that the debtor has charged to secure that obligation. A secured creditor has a priority and enforcement advantage over ordinary creditors who are dependent solely on the debtor's personal promise to pay. The priority advantage arises because the secured creditor's right to extract value from the charged property enables it to escape the principle that creditors of an insolvent debtor must share ratably in the balance of whatever assets the debtor may have, a principle that in Canada applies both in and outside of bankruptcy. The enforcement advantage consists in the secured creditor's recourse to specialized and expeditious remedies to support summary liquidation of the charged assets without the time and expense of having to obtain a formal judgment against the debtor.

Although the institution of secured credit has existed as long as notions of private property and freedom of contract, its legal and practical incidents have undergone periodic change in response to the emergence of new forms of property. Historically, land and luxury tangible things were the principal objects of security. With the transformation of western society from an agrarian to an industrial economy, the focus of property turned to from immovable to movable assets – equipment, raw materials and inventory – and from tangible to intangible assets – the account receivables owing to a business and its reified intangibles such as negotiable instruments, securities and documents of title. That change forced fundamental reform of the legal and institutional framework for secured credit in movables, beginning with federal Bank Act in the late part of the nineteenth century, and culminating in the comprehensive reforms to the movables secured transactions law of all Canadian province in the last quarter of the twentieth century.

With the modern shift to an information, technological and service based economy, intellectual property rights (IPRs) have begun to capture an increasing share of the value of the asset base of firms. With that shift has inevitably come the desire to maximize the collateral value of IPRs for secured lending purposes. This Report focuses on the practical and legal obstacles that may need to be addressed to facilitate access to secured credit based on IPRs. It was commissioned by the Law Commission of Canada in connection with its partnership in the Commercial Law Strategy of the Uniform Law Conference of Canada.

Increasing access to credit for enterprises with significant intellectual property assets can be seen as one element of a more comprehensive strategy for enhancing the competitiveness of Canada's information based enterprises.[3] The costs to the economy of impediments to the use of IPRs as collateral were succinctly described by one economist as follows:

> First, loans secured with intellectual property are more costly to negotiate and administer if they can be arranged at all. Second, alternative but less suitable and less efficient financial arrangements may be used in place of loan contracts. That is, proposed projects will still proceed but alternative and less appropriate financial arrangements may be used. For example, there may be more reliance on self-financing or love money than would otherwise be the case. Third, either because alternate financing is too costly or because alternate forms of financing cannot be obtained, some otherwise viable projects simply will not be undertaken.
>
> The resulting losses to the economy are of two kinds. On the projects which proceed using alternate forms of finance, the cost to the economy is the excess cost of the alternative contract. On the projects which do not proceed, the economy loses any excess of the return on the projects not undertaken over the returns on the projects undertaken instead.[4]

Although information-centered enterprises would benefit particularly from improved access to IPR-based lending, the advantages would be felt by all sectors of the economy. This is because there are very few firms today whose overall asset base does not depend on some form of

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[3]Other measures, such as improving the ability of firms to retain skilled employees, might also be an equally or more important part of the overall plan in this regard. We will not discuss such measures further, except to point out that increasing access to secured credit would complement rather than replace the other parts of an overall strategy.

[4]McFetridge at 2

intellectual property.  For instance, even if firms do not rely on intellectual property directly to produce revenue, they are likely to be dependent on computer software programs to enhance the efficiency with which they deliver their tangible goods or traditional services to the market place. The aggregate collateral value to a bank or other secured lender that holds security in all the assets of a business *except* its licensed software is substantially less than it would be with the software.

In its search for possible reform strategies, this Report builds directly on a series of research papers solicited by the Law Commission and presented at a Conference/Roundtable on Leveraging Knowledge Assets in November 2001.[5] Those papers highlighted two principal perceived impediments to the ability of a debtor to use its IPRs as security to obtain access to credit at lower cost.  The first is "the culture of traditional lenders and valuation problems."  The second is uncertainties and gaps in the federal and provincial laws governing intellectual property and secured transactions, along with the need for those laws to respond to the unique characteristics and demands posed by IPRs relative to other forms of property.

Part 2 of this Report looks at the extent to which the first of these perceived impediments – traditional lending culture and valuation difficulties – impedes the optimal utilization of intellectual property collateral.  We conclude that there is no evidence to support the perception that financiers are particularly hostile to intellectual property collateral independently of the valuation challenge.  As to the valuation issue, there is no question that intellectual property carries inherent difficulties.  However, these difficulties vary greatly according to context. Intellectual property rights that have proved their economic value by the reputation of the developer or a sufficient track record can be as "sound as houses" in terms of their reliability as collateral for the duration of their statutory life span.  On the other hand, for start up companies for whom access to competitive is most important, valuation can be a real obstacle particularly at the crucial development stage.  To a large extent these difficulties cannot be resolved by formal

[5] The Conference/Roundtable on Leveraging Knowledge Assets was held at the University of Western Ontario in London, Ontario and was organized with the Richard Ivey School of Business and the Faculty of Law of the University of Western Ontario.

governmental or legal intervention. The reasons lie in the inherent nature of IPRs to which improvements in the expertise and experience of valuation specialists is the most effective practical response. This is not to say that there are not certain features of intellectual property law that do not bear re-thinking in terms of whether their perceived benefit is worth the uncertainties created at the valuation level, and we give several examples of possible reforms of this kind.

In any event, the valuation challenge is not a reason to do nothing about the second perceived obstacle to optimizing the value of intellectual property collateral. The legal risk inherent in the current legal framework governing IPR-based secured lending is a problem about which this Report concludes something can and should be done. Indirectly it will serve to accelerate enhanced valuation practices.

The next Part of this report discusses the valuation challenges in more detail. Part 3 describes the deficiencies in the current framework of law and practice. Part 4 provides a broad overview of the alternative reform strategies and Parts 5 and 6 go on to discuss in detail the implementation, advantages and disadvantages of the two main alternatives. Part 7 discusses a number of issues related to licences of IPRs which are relevant to any reform strategy. Part 8 briefly touches on some enforcement concerns and Part 9 concludes.

### 1.2 **Federal versus Provincial Intellectual Property Rights**

Before examining the practical and legal difficulties associated with intellectual property as collateral, we need to be clear about what we mean by the term. For the purposes of this Report, the principal relevant classification is between intellectual property rights that fall within federal legislative jurisdiction ("federal IPRs") and those that fall within provincial authority ("provincial IPRs").

Federal IPRs consist of patents,[2] copyrights,[3] trade-marks,[4] industrial designs,[5] integrated circuit

[2] Patent law is expressly within federal jurisdiction by virtue of section 91(22) of the Constitution Act, 1867, "Patents of Invention and Discovery." Canadian patent law is contained in the federal *Patent Act*, R.S.C 1985, c.P-4.

topographies, [6] and plant breeders' rights,[7] each governed by its own separate federal Act. It is important to note that all of the federal IP Acts establish ownership registries. In the case of patents, industrial designs, plant breeders' rights and integrated circuit topographies and registered trade-marks, registration is a prerequisite to protection.[8] Unregistered copyright is accorded the same protection as registered copyrights – registration is relevant to proof of ownership and to assignments – and unregistered copyrights are pervasive and important.[9] As will become apparent, in so far as the issue of the approach to the law governing security interests is concerned, the key functional difference between various types of IPRs is the existence or absence of a federal ownership registry.

Provincial IPRs cannot be so easily defined. They are generally not created or regulated by any specific provincial Act or code, but arise instead under provincial law of general application. Examples include trade secrets and confidential information, personality rights, domain name rights, and unregistered trade-marks used within a province.[10] Defining the exact boundaries of

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[3] Copyright law is expressly within federal jurisdiction by virtue of section 91(23) of the Constitution Act, 1867, "Copyrights". Canadian copyright law is contained in the federal *Copyright Act*, R.S.C. 1985, c. C-42.

[4] Federal trade mark jurisdiction is based on Parliament's trade and commerce power. Canadian trademark law is contained in the federal *Trade-marks Act,* R.S.C. 1985, c. T-13.

[5] Protection for industrial designs is provided by the federal *Industrial Designs Act*. R.S.C. 1985, c.I-9.

[6] Protection for integrated circuit topographies is provided by the federal *Integrated Circuit Topography Act*, S.C. 1990, c.37.

[7] The federal *Plant Breeders' Rights Act*, S.C. 1990, c.20, provides protection to new varieties of prescribed categories of plants.

[8] See the *Patent Act* ss.10, 50; *Trade-marks* Act s.16; *Industrial Design Act* s.10; *Plant Breeders' Rights Act* s.27; *Integrated Circuit Topography Act* s.3.

[9] In addition, s. 7(b) of the *Trade-marks Act* is essentially a codification of the common law of passing off. Though its constitutionality was long in doubt, it has been held by the Federal Court of Appeal to be constitutional: see *Asbjorn Horgard A/S v. Gibbs/Nortac Industries Ltd.* (1987) 14 C.P.R. (3d) 314 (F.C.A.).

[10] The protection afforded trade-marks by provincial law is substantively very similar to the protection provided by the federal *Trade-marks Act*. Nonetheless, federal and provincial trade-marks constitute conceptually distinct items of collateral. Though it now appears that an action cannot be brought under provincial law so long as the mark in question is registered under the federal Act (see *Molson Breweries v Oland Breweries Ltd.* 2002 Ont. C. A. LEXIS 234) a mark may be protected by provincial law even though it is not registered under the *Trade-marks*

provincial IPRs is to some extent subjective. Fortunately, it is not necessary to come up with a precise inventory for the purposes of this Report. For reasons that will emerge, the principal valuation and legal challenges posed by IPR collateral arise in relation to federal IPRs.

Of the six categories of federal IPRs, this Report focuses primarily on patents, copyrights and trade-marks, as the most practically significant (although the principles discussed are readily translatable to industrial designs, integrated circuit topographies and plant breeders' rights):

> *Patents*: All patents are creatures of the federal *Patent Act* in the sense that, regardless of the merits of any particular invention, no patent protection exists until the patent has been issued. For this to occur, the patent application must first be scrutinized by the Patent Office. Only if it is found to be novel, useful and not obvious will a patent be issued.[11]
>
> *Copyrights*: Unlike patents, no formal application process is required to bring a copyright into existence. Copyright subsists in "every original literary, dramatic, musical and artistic work"[12] (with "literary work" including computer programs)[13] as soon as it is expressed in material form. Unregistered copyrights are pervasive and important.
> *Trade-marks*: Patents and copyright both give rights in information goods. In contrast, trade-marks protect an association between the particular goods or services and the provider of those wares by allowing the provider to exclusively identify their wares with a distinctive mark

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*Act*.

[11]See *Patent Act* ss.28.2, 28.3 and s.2 definition of "invention. There is an appeal process, ultimately to the Federal Court, for an applicant who is dissatisfied with a rejection: *ibid* s.41.

[12]*Copyright Act* s.5.

[13]*Ibid* s.2 definition of "literary work." The *Copyright Act* also protects so-called "neighboring rights" such as a performer's right in their performance. The assignment and registration provisions of the *Copyright Act* apply equally to these neighboring rights (see s.54 and s.2 definition of "copyright") and so for the purposes of this Report these neighboring rights can be assimilated to copyright *per se*.

## 1.3 IPR-Related Intangible Assets

The economic value to an owner of patents, copyrights and trademarks consists in the right to limit and control the use by others of the IPR without compensation. Control is typically exercised through the contractual licensing arrangements, under which the owner/licensor authorizes a licensee to use the IPR in exchange for either an up-front payment or payments over time. The licensor/licensee element produces its own set of potential assets that can potentially be used as collateral by the licensor or the licensee as debtor. Although this Report focuses on federal IPRs, it also covers the use as collateral of these associated rights.

For the licensor, there are the contractual benefits it derives from its licencing arrangements, most notably the stream of royalty payments owed by licensees, which may be assigned as collateral separately or in combination with the licensor's aggregate of rights against the licensee or both in combination with the IPR right itself. For the licensee, the relevant collateral consists in the value derived from its right to use the intellectual property in accordance with the terms of the licensing contract.

It is possible to structure licensing arrangements in a more complex fashion. The owner/licensor might grant a first-level licensee the right not simply to use the IPR but to sub-licence it to end-users. In such an arrangement, the first-level licensee's potential collateral would include not just the value of its rights under the licence, but also the potential to separately collateralize the stream of revenues derived from its sub-licensing arrangements with end-users. For the sake of simplicity of discussion, we will assume a simple licensor/owner and licensee/end-user structure since the basic issues remain the same even in the context of a series of licences.

The debtor/owner's right of suit for damages for IP infringement constitutes a potentially important source of collateral in itself. As an associated intangible, in our view it is best regulated like royalty payments and licences under general secured transactions law. However, the PPSAs at present exclude collateral in the form of a right to sue in tort from their scope (though arguably not the fruits of such a suit) and this may exclude at least partially IP infringement causes of action.   We endorse prior recommendations (see Cuming & Walsh) to eliminate this exclusion, a reform that would permit creditors who take security in this form of collateral as part of a general collateral package of intangibles to rely on the general PPSA legal framework. .

## 2 Valuation Challenges

### 2.1 Introduction

Cultural inertia is sometimes suggested as a reason for the reluctance of traditional financial institutions to engage in IPR-based financing.  However, the research previously solicited by the Commission provides no reason to believe that access to IPR-based collateral is negatively influenced by an irrational lack of appreciation of the value of IPRs on the part of financial institutions.  Indeed, the contrary is suggested by the emergence, despite legal hurdles, of specialized IPR-based lending techniques by lenders in some industries, film financing in particular.[14]  It follows that efforts to improve access to credit by sensitization of lenders to the opportunities available are not likely to bear fruit.

But while financial institutions may be generally sensitive to the collateral opportunities presented by IPRs, the Commission's previously commissioned research identifies a number of inherent valuation challenges that may explain why lenders are often perceived to be more cautious when it comes to IPR-based financing relative to secured financing against the value of more traditional categories of property.  This chapter lists and explains these inherent valuation challenges.  We describe them as "inherent" because they arise from substantive and procedural

[14] See the discussion in Townend of film financing in the U.K.. For a discussion of film financing in the U.S see the prepared statement of Fritz Attaway, Senior Vice President for Congressional Affairs and General Counsel, Motion Picture Association of America (MPAA), submitted as part of the Intellectual Property Security Registration: Hearings Before the House Subcomm. on Courts and Intellectual Property of the House Comm. on the Judiciary, 106th Cong., 1st Sess. (June 24, 1999) available at http://commdocs.house.gov/committees/judiciary/hju62500.000/hju62500_0f.htm, p.62.  See also the description by Mann of the role of secured debt in software development and software acquisition financing.

principles of intellectual property law, which, with a few minor exceptions, we conclude cannot be changed without compromising the public policies and goals of intellectual property law to any unacceptable degree.

## 2.2 **Limited legal life**

The legal protection afforded intellectual property rights is based on the theory that economic reward provides an incentive to would-be inventors and artists. But this must be balanced against the public interest in free access to the accumulated intellectual capital of human knowledge so as to promote further cycles of innovation. The balance between these two policies is achieved by limiting the duration of the legal existence of patents and copyrights, at the conclusion of which the knowledge falls into the public domain and can be exploited by anybody without legal interference.

In the case of patents, once the patent is issued, the patentee's monopoly over the subject matter of the patent[15] is limited to a term of twenty years from the date on which the application was filed,[16] subject to the payment of maintenance fees.[17] For copyrights, the term of protection is longer: the life of the author plus fifty years.[18] However, where the first owner of the copyright is the author, ownership reverts to the heirs of the author 25 years after the death of the author notwithstanding a previous assignment to a second owner.[19]

Trade-marks are not subject to any *a priori* legal life span. Registration under the federal *Trade-marks Act* protects the mark for an initial period of 15 years and may be renewed indefinitely.

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[15] *Patent Act* s.42 "Every patent granted under this Act shall . . .grant to the patentee. . .the exclusive right, privilege and liberty of making, constructing and using the invention and selling it to others to be used. . ."

[16] *Ibid* ss. 43, 44. This term applies to patents applied for after 1 October 1989.

[17] *Ibid* s.46.

[18] *Copyright Act* s.6.

[19] *Ibid* s.14.

However, the trade-mark is lost if abandoned by the owner or, as explained later, if it loses its distinctiveness.  Because the legal life of trade-marks thus depends on vigilant and continuous monitoring by the owner, it too has a potentially limited legal life that must be accommodated by lenders at the initial valuation stage.

### 2.3 **Limited economic life**

IPRs have a limited economic life that can be much shorter than their legal life:  "IP by its very nature is concerned with innovation, and because it is a monopoly granted to encourage further innovation, there is a fundamental problem in the valuation of IP: that IP can be made worthless through becoming obsolete in the market place."[20]  The tendency to obsolescence is particularly accelerated for some forms of IPRs.  For instance, computer software that "implements cutting edge technology can become fatally inferior to newly developed products in just a short time."[21]

Because the realizable value of the IPR may have become negligible by the time the debtor defaults and the creditor seeks to enforce its security, lenders must have the expertise to anticipate the extent to which this risk afflicts the particular borrower's IPRs and discount the value of the collateral accordingly.  Even when existing circumstances suggest every reason for confidence in a lucrative return, the duration of the practical life of an IPR is still unpredictable to some degree since it is dependent in part on future factors beyond the control of the debtor (e.g. superior research efforts by competitors or unanticipated product deficiencies).  This is also true of trade-marks, which may depend on future fashion trends and marketing for their value.

### 2.4 **Idiosyncratic value**

Some IPRs, such as many of the patents in the portfolio of a R&D intensive company, have no

[20]Townend at 17.  See also Lipton, at 18 "Additionally, certain information products, such as a particular generation of computer software, whether or not protected by patent, may have a commercial value that lasts for a maximum of two or three years;" and Smith, at 19  "The average life of a patent is about 5 years."

[21]Mann at 139.

ready market. This is not to say that there is no market at all (although there may not be), but each IPR is to some extent unique and so valuing the asset is more difficult than in the case of more fungible goods, such as wheat or televisions, which are routinely traded on an established market. This increases the cost of valuing the collateral and so increases the cost of using it as security, particularly if the IPR is to be the primary security.[22]

The idiosyncratic value problem particularly acute if the enterprise is a new one without a proven track record that is in need of financing to fund it through the early development stage. For these would-be borrowers, access to financing is essentially limited to those financial institutions with sufficient accumulated experience to assess the credibility of the enterprise's business plan for the particular category of IP under development.[23]

## 2.5 **High Use Value Versus Low Liquidated Value**

The value of IPRs is often much higher in the hands of the debtor compared to its value in the hands of a new user. For instance, patents and copyrights may be only aspects of an overall product that relies for part of its value on the know-how embodied in the debtor/owner or in a "hybrid, patent-trade secret combination"[24] Because the value of the IPR is thus dependent on unique characteristics of the particular debtor/owner, it may have little market value in the traditional secured lending sense under which a lender depends on the liquidated value of the collateral as protection against the risk of non payment by the debtor.[25] Should the debtor default, the only potential interested purchasers on a liquidation sale may be the debtors'

[22]"There is simply not an active market for intellectual property assets, and most often when they happen to be exchanged, the details are not publicly available. . . .The requirement for comparability is a substantial barrier to the use of the market approach for intellectual property. This property, by its nature, tends to be unique and sales of similar properties are very difficult to find." Smith at 8

[23]See e.g. Mann at 155.

[24]Smith at 25; see also McFetridge at 4.

[25]"Lenders should also be aware that the nature of intellectual property differs from most forms of tangible property, in that many forms of intellectual property will flourish only in the hands of their developers." Lipton at 22.

competitors, who will likely already have their own IP in place, and will be willing to purchase the IPR only for the value comprised in keeping it out of the hands of a reborn competitor as opposed to its value in the hands of the debtor.[26]

A similar difficulty limits the collateral value of an item of intellectual property purchased by a debtor from the owner. In many cases, the use value of the IP in the debtor's business depends on the ongoing technical advice and maintenance support of the owner/developer, an obvious example being the continuing support including the provision of upgrades needed to maintain the value of software. Unless the secured creditor can force the owner/developer to provide those ancillary services to a new user, the liquidated value of the IP is substantially diminished.

To the extent the value of IPRs thus depends on the ongoing expert service of the owner, the collateral value to the owner/debtor of the income stream owed to it by end-users is also diminished. Once the defaulting debtor is no longer in business so that ongoing maintenance is no longer assured, end-users may claim that breach of the maintenance obligation relieves them of their obligation to make continuing payments.[27]

## 2.6 **Uncertain Validity or Enforceability**

The owner's ability to exploit the economic value of its IPRs depends on its ability to control the use and sale of the right by others. Yet the legal validity and enforceability of IPRs.is not always predictable for reasons that vary as between patent, copyright, and trade-marks.

*Patents*

[26]"The sales team has to create a "legend" as to why this division's prospects were hampered by the corporate grip, so that some new owner might unleash its potential.. . .The only basis for selling the patents is to attest to the buyers about the incompetence of the prior managers (presumably the patents are still valid, and the market prospects remain good)." Rutenberg at 5.

[27]See Mann at 141.

Even after a patent has been issued, its validity may be challenged in court at any time during its life for any of the substantive reasons that would have justified the Patent Office in refusing to issue a patent in the first instance: i.e., lack of novelty or utility or obviousness. Because invalidity is a not uncommonly successful defence to a claim for patent infringement, the collateral value of a debtor's patents, particularly at the early stages, must be discounted to account for this risk.[28]

*Trade-marks*

Invalidity may also be raised as a defence to a trade-mark infringement action. Because the function of a trade-mark is to provide the consumer with information about the origin of the wares associated with that trade-mark, the mark must be "distinctive" of the source of the wares: that is, there must be a unique association between the wares and a single source. If the wares lose distinctiveness – for example if a competing source provides the same wares under the same mark without interference from the holder of the mark[29] – the mark will become invalid.[30] Thus even if initially valid, trade-marks may become invalid if not properly maintained and policed by the owner. The secured lender must take this risk into account at the valuation stage.

The requirement for distinctiveness also means that secured lenders cannot rely on trademarks as independent collateral. At one time, trade-marks could not be assigned "in gross" which is to say they could not be assigned independently of the business as a whole. This was thought to be unduly restrictive of commercial practice and the Act now provides that a trade-mark "is transferable . . .either in connection with or separately from the goodwill of the business. . ."[31] However, the courts, still concerned with the ultimate goal of protecting the consumer, have held

[28] McFetridge at 4.

[29] As occurred for example in respect of the mark WATS for telephone services: see *Unitel Communications Inc. v. Bell Canada* (1995) 61 C.P.R. (3d) 12 (F.C.T.D.).

[30] *Trade-marks Act* s.18(1)(b).

[31] *Trade-marks Act* s.48(1).

that though the Act provides that the mark may be assigned in gross, it does not ensure that the mark will remain valid after such an assignment. Thus if the mark is associated with one source, and the bare mark is assigned to another company which begins to use it on the same wares, the mark is now associated with two sources – the old and the new – and may therefore lose its distinctiveness and become invalid.[32] For this reason, it is risky to take a security interest in a bare trade-mark, since realization by selling the mark to a third party, unaccompanied by the goodwill in the business as a whole, may well lead to invalidity of the mark. This does not occur if the mark is transferred as part of the assignment of the assets generally, so a security interest in important trade-marks may still be a valuable adjunct to a general security interest in the aggregate assets of the debtor enterprise.

*Copyrights*

Registration of copyrights is not a pre-condition to their validity. The copyright comes into existence as soon as it is expressed in material form. Invalidity *per se* is not that common a defence in a copyright infringement action.[33] The issue is more one of uncertain enforceablity. Either it is claimed that the defendant did not copy the plaintiff's work (copying may be more difficult to establish than one might imagine, given that copyright protection may subsist in somewhat abstract aspects of a work, such as a plot line); or that what was copied or allegedly copied was unprotectable, as copyright protects only the expression of the work, as opposed to the idea behind it.[34] The protected "expression" extends beyond the literal text of a work; for example fictional characters, if sufficiently well delineated, and detailed plot lines may be protected. But at a the higher levels of abstraction the idea or theme of a work is not protected. The valuation difficulty arises because it is not always possible to predict in advance of a court ruling the precise dividing line between protected expression and the unprotected underlying idea

[32] See *Heintzman v. 751056 Ontario Ltd.* (1990) 34 C.P.R. (3d) 1(F.C.T.D.) for an example where this occurred.

[33] Though lack of originality or expiration of the term of protection are possible attacks on the validity of the copyright.

[34] *Cuisenaire v. South West Imports Ltd.* (1968) 57 C.P.R. 76 (S.C.C.).

or theme

Moral rights present a potential additional complication to the valuation of copyrights. The *Copyright Act* separately protects an author's "moral rights," including the right to the integrity of the work and the right to be associated with the work.[35] Although moral rights may be waived, they cannot be assigned. It follows that without proof of a comprehensive waiver, the value of the copyright in the hands of a non-author owner/debtor is reduced by the potential for continued authorial interference and control.

## 2.7 **Impact on Valuation of IPR-Associated Collateral**

It may be thought that valuation is not as serious a problem where the lender is primarily relying on the royalty payments derived from IPRs. After all, here the collateral is a monetary receivable. However, the valuation uncertainties surrounding IPR rights have an impact on a secured creditor's determination of whether the likely future royalties derived from the IPRs will be sufficient to fully amortize the secured obligation (or the value of the securities to be issued where an assignment of royalties is made in the context of a securitization of royalty payments collateralized by IPRs). Unlike loans collateralized by real or personal property where the obligor normally pays a pre-determined monthly sum, intellectual property royalties are frequently paid based upon sales, and sales can vary widely and unexpectedly, especially if a band becomes unpopular or a patent is declared invalid or is superceded by a better product. In the case of patents, the obligation to make royalty payments may end if the patent is later found to be invalid.

## 2.8 **Possible Responses**

### 2.8.1 **Introduction**

[35] *Copyright Act* s.14.1.

The extent to which the inherent valuation challenges identified above diminish the attractiveness of IP collateral for secured lenders can vary considerably from one transaction to the next. Some IPRs, for example, a patent on a 'blockbuster' pharmaceutical, or the copyright on a popular film, pose little in the way of valuation difficulties by reason of their proven track record. The example of David Bowie's aggregate copyrights in his music mentioned by Knopf [36] shows that financiers may also be willing to rely on the value of a debtor's portfolio of patent or copyright rights aggregated as a whole provided that the economic value of at least some of the items within the portfolio have a sufficient historical track record even if the valuation of other items is unpredictable. In still other cases, lenders may be willing to rely on IP collateral by reason simply of the creator's established reputation in relation to past IP products of the same genre.

These examples aside, it is clear that in many instances, the unique characteristics of IPRs impose inherent valuation constraints on IPR-based secured lending relative to more traditional types of collateral. What, if anything, can be done to reduce the impediments to the reliability of IP collateral that these valuation challenge inevitably pose for secured lenders?

The prior research solicited by the Law Commission indicates that the valuation challenge presented by what was identified above as the "idiosyncratic" nature of intellectual property will be lessened as lenders acquire greater familiarity with the IP world and specialized expertise This is a process which will unfold naturally, without the need in our view for formal governmental intervention as IPRs acquire a more pervasive share of business debtor assets.[37] And empirical research indicates that general institutional lenders are increasingly prepared to extend IPR-based secured financing even at the product development stage if venture capital

[36] Knopf at 4.

[37] "The development of a successful IP security market depends on a growing market confidence. This comes first from established companies leading lenders into a more favourable attitude towards the risks of lending against IP. From this gradual change of gradual attitude opportunities develop for smaller, younger companies as the market gains in confidence and extends the boundaries of the risks that it has experience of and will consider. This is based upon a prediction that the reform of the law will not simply open a new stall in the market place at which all the current lenders, including the traditional high street lenders, will lend to all IP-rich companies from the oldest to the youngest. Rather, the market will develop over time as non-specialist accountants, lawyers, patent agents, and bankers slowly become comfortable will the new security possibilities from IP." Townend at 20.

financing is also in place so as to enable the bank to informally rely on the latter's expert and specialized judgment.[38] As IPRs become more commonly used as collateral, valuation techniques will improve thus allowing more widespread use of IPRs as security. In other words, a 'virtuous circle' may be created.

### 2.8.2 **Substantive IP Law Reform**

However, a number of the inherent valuation challenges identified above are not attributable to a lack of valuation expertise as regards IPRs. Rather they stem from substantive or procedural features of the current Canadian legal framework governing IPRs and related rights. While amendment of these features could reduce uncertainties at the collateral valuation level, this must be balanced against the possibility of undermining important principles of intellectual property law.

For instance, making registration of copyrights a pre-condition to their validity would enable secured creditors to more easily determine the existence and extent of a debtor's prima facie copyrights. However, such a requirement would run afoul of Canada's international obligations under the Berne Convention which prohibits the imposition of formalities as a pre-requisite to the right to copyright protection. As another example, we noted earlier that lobbying by businesses to facilitate commercial transactions involving trademarks eventually led to legislative amendments to permit assignments "in gross". However, the practical impact of this reform has been largely negated by judicial decisions holding that a trade-mark assigned independently of the business with whose it is associated is likely to be found invalid. This effect of this jurisprudence undoubtedly reduces the commercial and collateral value of trade-marks. However, it is fully compatible with the fundamental policy of trade-marks, which is to provide reliable information to consumers as to the source of the wares associated with the trademark.

It has been suggested that valuation risk posed by potential invalidity could be reduced for

[38] See generally Mann.

patents and similar IPRs by limiting the time within which challenges can be made to validity. For instance, Townend suggests that a "successful security market for IP requires detailed scrutiny prior to registration or creation of the right and, leading from this, a limited time within which challenges can be made to the validity of IP, for example within the first year after the product is made available to the public."[39] But this scheme would almost certainly immunize many invalid patents from challenge. It is extremely unlikely that the negative economic effects of thus protecting unjustified monopolies will be offset by the benefits obtained at the level of enhancing overall access to IPR-based secured credit. A less radical way of addressing the invalidity problem would be to devote more resources to initial examination of a patent application by the Patent Office in order to improve the quality of issued patents. However, it is by no means clear that such a step would be cost-effective, since the more stringent examination process would apply even to those patents which are never used as collateral or never challenged.

This is not to say that there are *no* changes to IP law and institutions that might help to reduce valuation uncertainty without adverse substantive effects on the integrity of intellectual property legal policy. For instance, it was earlier noted earlier that where the first owner of the copyright is the author, ownership reverts to the heirs of the author 25 years after the death of the author notwithstanding any previous assignment.[40] The policy rationale for this rule is not clear even though the risks it poses to the predictability of duration of the legal life of an assignee/debtor's copyright protection has some negative impact on the value of the copyright as collateral.

Moral rights are another instance where legal reform might reduce valuation risk without damage to fundamental intellectual property policy. The non-assignability of moral rights may adversely affect the collateral value of the IP in the hands of an assignee/debtor because the author's retention of control reduces the liquidated value of the IPR should the debtor default. The valuation risk this poses is unpredictable since the circumstances in which the rights can be

[39] Townend at 22.

[40] See Spring-Zimmerman et al at 6 indicating that this is a concern for secured lenders. Presumably the effect is modest.

exercised are difficult to determine in advance. These difficulties can be alleviated by securing a waiver of moral rights from the author and it is common practice to require a waiver on taking an original assignment from the author.[41] In this respect, the Copyright Act provides that where "a waiver of any moral right is made in favour of an owner or a licensee of copyright, it may be invoked by any person authorized by the owner or licensee to use the work, unless there is an indication to the contrary in the waiver."[42] It is unclear from this wording whether a subsequent assignee or a secured party, or a purchaser of the copyright from a secured party on default, would be considered a person "authorized by the owner" to use the work so as to be entitled to invoke the benefit of such a waiver. The Act might usefully be amended to provide that in the absence of a contrary indication, the benefits of an authorial waiver extend to subsequent assignees and to the secured creditors of the original assignee and any subsequent assignee. In addition, in the case of registered copyrights, the author should be required to indicate on the record an intention to retain moral rights as a condition of their exercise against subsequent assignees and secured creditors.

### 2.8.3 **Reform of Framework for IP-Based Secured Transactions**

We have noted that valuation of IPRs is likely to improve as use of IPRs as collateral becomes more common and conversely it will become more common as valuation improves. Thus it has been suggested that reform of the law governing IP secured financing will encourage further investment by lenders in the acquisition of valuation practice. Or, to put the point in the opposite fashion, the extent to which legal risk raises the cost of lending based on IPRs indirectly impede the development of valuation techniques. As Townend remarks:

> . . .if the law was amended . . .to reduce the complexities for creating security, then the market could allow for more widespread securitisation. Conversely, as the opportunities to use IP as security became more widely accepted by a broader group of lenders over a broader spread of IP, then there would be a further need for a reduction in complexity in

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[41] Mercier at 65.

[42] *Copyright Act* s.14.1(4).

> the law and greater transparency in the rules. This would allow strangers to trust not in each other as the primary source of risk management, but in the vehicles of security and the reliability of the law. This must be the central aim in the reform of security legislation, to develop a legal environment that makes the taking of security over IP as common place as the taking of security over houses in the residential property market.[43]

With this said, it should be recognized that legal system reform is unlikely to open the floodgates to widespread lending on the basis of IPRs because of valuation problems which are to some extent are inherent in the nature of IPRs. But as IPRs become a more significant proportion of debtor assets valuation will improve and IPRs will become increasingly important as collateral. It also appears that reform of the legal system may be an indirect step towards improved valuation as well as being directly beneficial in reducing legal costs.

## 2.9 Summary and Recommendations

Formal governmental action directed at improving the valuation expertise of financiers of IP collateral is not required.

The inherent legal nature and characteristics of intellectual property pose valuation risks for secured creditors of a different nature and extent that arise in relation to other types of property. With the exception of the points noted in the recommendations listed below, this valuation risk cannot be reduced by changing the legal incidents and attributes of intellectual property without compromising fundamental policies of intellectual property law to an unacceptable extent.

The policy justification for the rule whereby, if the first owner of the copyright is the author, ownership reverts to the author's heirs 25 years after the author's death notwithstanding any previous assignment, should be revisited to determine whether it is justified despite its negative impact on the predictability of the future value of copyright collateral.

[43] Townend at 44.

The non-assignability of authorial moral rights reduces the value of copyrights and renders valuation more unpredictable. Although moral rights may be waived, the scope of the beneficiaries entitled to take advantage of a waiver is unclear under the current Copyright Act. The relevant provisions should be amended to confirm that subsequent assignees and secured creditors are entitled to invoke the benefit of a waiver executed in favour of a prior assignee in the absence of a contrary intention. Consideration might also be given to amending the Act to provide, that in the case of registered copyrights, registration of the author's intention to retain moral rights is a pre-condition to the effectiveness of those rights against subsequent assignees and secured creditors.

## 3 Uncertainties in Existing Law and Practice Related to Security in IPRs

### 3.1 The Problem

The law relating to security interests federal IPRs is radically uncertain. Though all the federal IP Acts establish ownership registries of one form or another, they were not intended to facilitate the use of the IPRs as collateral. None of the six existing federal intellectual property statutes expressly addresses the secured financing aspects of intellectual property law. Their application to security interests arises purely by implication from the federal provisions that provide for the assignment or transfer of the relevant kind of intellectual property right, and for the establishment of federal intellectual property registries to record ownership of the right and its transfer.[44] The impact of the federal assignment and registry provisions on security has been extensively analyzed, but these analyses do not allow any firm conclusions to be drawn.[45] On the contrary,

[44] *Copyright Act*, ss. 27(1), 57; *Patent Act*, ss. 50(1), 51; *Trade-marks Act* s. 48(1); *Industrial Design Act*, s. 13(1); *Plant Breeders' Rights Act*, s. 31(1); *Integrated Circuit Topography Act*, s. 7(1), s.21.

[45] In addition to the papers prepared for the Leveraging Knowledge Assets Conference/Roundtable by Wood, Spring-Zimmerman et al, Knopf, Adams & Takach, and Duggan see also Cuming & Wood; Wood, (2002); Mercier & Haigh; and Gold.

there is a general, indeed universal, consensus that there is fundamental uncertainty with respect to essentially all of the basic questions regarding the effect of the federal provisions on security and the relationship between the federal and provincial systems.

The first step any creditor relying on IP collateral must take is to identify the existence, nature and extent of the debtor's IPRs. This may seem like a straightforward matter in view of the existence of federal registries for recording the assignment and transfer of all six categories of federal IPRS. In fact, the federal acts as currently drafted mean that the federal registry is not a reliable indicator of the debtor's clear title to the relevant IPR. In the first place, under three of the federal IP Acts (including the *Trade-marks Act* ), registration is not a pre-requisite to the validity and effectiveness of a transfer against third parties taking from or under the transferor. It follows that a secured creditor cannot rely on the results of a registry search as a guarantee against the risk that the debtor, though apparently the owner or assignee of record, has previously disposed of the relevant IPR. As long as the prior unregistered assignment complies with the requirements for a valid transfer under the relevant federal statute, the title acquired by the intervening unregistered transferee would prevail.[46] Existing practice in respect of "registration" of security interests compounds the confusion. The Registrar of Trade-marks will make an annotation on the record indicating that it has received a security agreement purporting to affect the trade-mark in question, but this practice is not sanctioned by the legislation and its effect is unclear. Whether it might constitute constructive notice and whether failure to register a security agreement in this way might be considered a fraud on subsequent parties, is unclear.[47] *A fortiori*, the priorities between a provincially registered security interest in a registered trade-mark and one which is registered federally according to this practice of the trade-mark office is so obscure as to almost be beyond speculation.

The other three federal IP Acts, including the *Patent Act* and the *Copyright Act*, provide somewhat greater protection against the risks posed by unregistered prior assignments. Under

[46] Wood at 4.

[47] Spring-Zimmerman at 20; Knopf at 50 ff.

these Acts, an unregistered assignment is void against a subsequent assignee without notice who registers first. Consequently, if the assignment under which the debtor acquired title is registered, and assuming an unbroken chain of title from the original owner, a secured creditor can generally rely on the registry record as a reliable indicator of the debtor/assignee's title. But registration does not absolutely guarantee priority over a prior unregistered assignee. The first-registered assignee must be without actual notice of any prior unregistered assignment.[48] The actual notice qualification creates some residual uncertainty since its application depends on the subjective state of knowledge of the debtor/assignee.

Moreover, registration under these Acts does not necessarily guarantee that the registered assignee's title will prevail against a subsequent assignee from the same assignor. It has been held judicially that registration has negative priority effect only.[49] It prevents a prior unregistered assignee from prevailing against an innocent subsequent assignee who registers. But it does not create a positive first-to-register rule of priority so as to preclude a subsequent assignee from relying on any exception to first-in-time priority created by otherwise applicable general property law principles. It follows that a secured creditor faces the legal risk that a debtor's federally registered title may be defeated by a subsequent assignment to a different assignee by operation of other law.

Further, it is not clear whether "assignment" includes transactions creating a security interest. And if the registration provisions do apply to apply to transactions creating a security interest, it is likely (but not certain) that the form of the transaction is important, and that only to those security agreements which in the form involve a transfer of title are registrable federally.[50] For

[48]See Wood at 4 ff. The requirement that the subsequent assignee be without actual notice is express in the *Copyright Act* and the *Plant Breeders' Rights Act* and has been read into the *Patent Act* by the decision of the Appellate Division of the Alberta Supreme Court in *Colpitts v. Sherwood* [1927] 3 D.L.R. 7. The *Colpitts* decision is consistent with the Supreme Court decision in *United Trust Co. v. Dominion Stores Ltd.* [1977] 2 S.C.R. 915 holding that the doctrine of actual notice applies unless specifically ousted by legislation.

[49]See the controversial Federal Court decision to this effect in the *Poolman v. Eiffel Productions S.A* (1991) 35 C.P.R. (3d) 384 (F.C.T.D.) and the commentary in Spring-Zimmerman et al at 26ff and Wood at 30ff.

[50]Wood at 4; Spring-Zimmerman at 18.

many common forms of security agreement it may be difficult to determine whether a transfer of title is involved and so whether the agreement is registrable federally.[51] Priorities as between federally and provincially registered security interests are also unclear. It is unclear whether the provincial security Acts would apply at all, and there may be some variation between provinces on this point.[52] If the provincial Acts did apply, the outcome of priority contests would probably depend on the form of the security agreement.[53]

Apart from this profound legal uncertainty, there are many uncertainties associated with current registry practices. Patent, copyright and trade-marks databases are currently accessible on-line, but the on-line source is not adequate for due diligence searching in respect of financing. None of the on-line databases are guaranteed to disclose all relevant information and such information as is disclosed may be several weeks out of date.[54] Security agreement information does not appear at all in the on-line patent database.[55] As Knopf notes "Such uncertainty does not exist and would not be considered acceptable in other Canadian registration regimes, such as those for real estate or PPSA filings."[56]

## 3.2 The Need for Reform

It is little exaggeration to say that the law relating to security interests in federal IPRs could not be moire uncertain. The question is, what, if anything, should be done about it.

The first question is whether reform is needed at all. Legal practitioners are clearly not satisfied

[51] Wood *ibid*.

[52] Wood *ibid* at 26 ff.

[53] *Ibid*

[54] Knopf at 43 ff.

[55] *Ibid.*

[56] *Ibid* at 44.

with the current uncertainty, but lenders are generally advised to use a "belt and suspenders" approach, in which all interests are registered both federally and provincially. If the only additional cost of the uncertainty is this dual filing, it might be argued, then reform is not essential, particularly since the provincial filing would often be required in any event as part of a general security agreement. Prior research has tended to focus on the sources of current legal uncertainty, accepting that the case for reform is self-evident.[57] Certainly no attempt has been made to quantify the impact of this uncertainty on the cost of lending.

With that said, we can at least identify the general nature of the excess costs of the current regime.

> Registering valid security against intellectual property is plagued with uncertainty and unique issues due to the interaction and potential conflict between provincial and federal law. The result at present is that borrowers who use their intellectual property as collateral can expect higher than usual borrowing transaction costs and increased reporting requirements. Lenders can likewise expect increased administrative burden in monitoring borrowers and somewhat less certainty respecting the quality of the security obtained from the borrower.[58]

It may also be that the savings achieved by reform will increase as IP-based secured lending becomes a more significant source of financing for information based firms. As Knopf observes,

> It may be that the pressures for or against revision are somewhat or even very time-sensitive and situation-specific. Anecdotal evidence suggests that asset based lending was not extremely important in the very bullish equity markets that fuelled the rise of the "dot com" businesses in the late 1990s. This contrasts with the earlier 1990s which were driven by recession and the need to raise money based upon whatever assets were at hand,

[57] McFetridge notes at 3 that "The loss to the economy due to the use of less efficient forms of finance would be difficult to measure in practice."

[58] Robert Betteridge, "Pinning Jello To The Wall: Security Interests In Intellectual Property" On Record, Burnet, Duckworth & Palmer LLP http://www.bdplaw.com/articles/spring01/spring01d.htm as quoted by McFetridge at 2.

> since there was little interest in equity financing at that time. Perhaps not surprisingly, this was the period at which demand for legislative reform in these areas last peaked.
>
> Consequently, it would appear that demand for improvement of the legal framework in this area will increase if the economy worsens and asset based financing makes a resurgence. Moreover, the related questions arising in bankruptcy and insolvency will become more important if there are hard times ahead, especially in the high tech sector which is so dependent on licensing.[59]

The current recession in technology industries is unlikely to be permanent, nor is the "dot com" frenzy likely to re-occur. This suggests that as the sector recovers the demand for secured debt will also increase. Though satisfaction of this demand may be retarded by legal uncertainty, some secured lending based on IPRs will take place. As it does, the uncertainties that were historically unimportant will eventually be resolved through litigation. This will be expensive in itself. And as uncertainties are resolved, some proportion of lenders will find that their assumptions have been wrong and there will be additional expense as the lending community adjusts to the results which will be at least partially unanticipated.

Although the benefits of a reformed system for security in IPRs are difficult to quantify, we believe that the current level of inefficiency and uncertainty is unacceptable in what is destined to become a major area of secured lending. This view reflects a widespread consensus that reform is necessary.

## 3.3 **Generic Federal Registry Reforms**

Many of the reforms which are needed to implement an effective system for security in IPRs are dependent on the approach taken to the division of responsibilities between the federal and provincial spheres. The next several chapters of the report are concerned with these aspects of

[59] Knopf at 80.

reform.  But there are some reforms to the federal registry system which are needed no matter what approach is adopted.

We will see below[60] that the federal ownership registries are an integral part of the provincial approach to security interests in IPRs, since chain of title searching through the federal ownership registry is necessary to establishing good security in IPRs even under that approach. *A fortiori* modernized federal registries are needed if a federal approach is to be adopted.

Though considerable progress has been made in making federal IPR database information available on-line, these efforts have been aimed primarily at substantive searching for e.g. patent prior art, or similar trade-marks, and the systems remain inadequate for chain of title searching. Some basic technological changes will be are needed to the federal IPR ownership registries if the provincial system is to be effectively implemented.  In particular, legally reliable, up to date, on-line searching of the federal ownership registries, including full chain of title for all IPRs (that is, grantor/grantee searching), is important.  Otherwise it will not be possible to take a fully protected security interest in a debtor's federal IPR without the cost and delay of a search at the CIPO offices in any case where the debtor is not the original owner of any of its IPRs.

Legal change is also desirable.  As we have seen, at present the form of the security agreement is important with respect to registration in the federal system.  A reformed system would adopt the substance over form approach which is used in the provincial systems.  This should not be controversial.  Further, debtor name rules should be specified to improve search reliability.
We recommend repeal of the existing qualification based on actual knowledge of a prior assignment by the first registered assignee in favour of an unqualified first to register rule.  This recommendation is in line with contemporary legal policy  for both land and movables registries. Allowing priority based on actual notice can prevent sharp dealing in some circumstances, but it can lead to increased litigation by undermining the completeness of the registry.[61]

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[60] *Infra* Part 5 "The Provincial Approach"

[61] A discussion of the disadvantages of the doctrine which is still current is found in the 1857 Report of the

Finally, we recommend that all licences which are in substance (partial) assignments of the rights in the IPRs should be subject to the federal ownership registration regime. The usual view, which we adopt, is that it is exclusive licences which are functionally equivalent to (partial) assignments and so should be subject to the ownership registration regime.

### 3.4 **Summary and Recommendations**

In our view, legislative authority over all aspects relating to ownership and the third party effects of the assignment and transfer of federal IPRs should be exercised exclusively at the federal level. The supplementary application of otherwise applicable provincial law principles creates uncertainty both because of the lack of conscious coordination between the federal and provincial rules and because of the difficulty of predicting which provincial (or other) laws may intersect with the federal rules.

However, if federal law is to provide certain, reliable and predictable guidance, the substantive provisions relating to the third party effects of registration in the federal IP registries need to be expanded to provide a fully comprehensive regime. In our view, this would best be accomplished by

reforming the federal intellectual property statutes to provide:

(1) that federal registration of an assignment or transfer of any federal IPR is an absolute pre-requisite to its third party effectiveness even if the federal IPR is not itself registered as will often be the case for copyrights;

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Royal Commission on Registration of Title in England, quoted by Laskin C.J. dissenting in the leading Canadian case on the issue, *United Trust Co. v. Dominion Stores Ltd.* [1977] 2 S.C.R. 915.

(2) that successive assignments or transfers of the same IPR by the same assignor are ranked on a strict first-to-register basis.

(3) that all exclusive licences should be subject to the federal ownership registration regime.

Reform of the federal substantive rules governing the registration and priority status of assignments and transfers of federal IPRs will produce little real benefit unless the federal IPR registries are significantly reformed to permit cheap and efficient remote access. Because structural reform of this kind is relevant to additional issues of substantive reform to be discussed imminently, we will defer making detailed recommendations until later in the Report.

## 4 Possible Reform Strategies

### 4.1 Overview

In this Report we take the continued existence of federal ownership registries for federal IPRs as a basic constraint on reform strategies.[62] We also take it that no federal ownership registry will be created for provincial IPRs (even assuming that this would be constitutionally permissible). The reform possibilities therefore relate to the choice of law which will govern security interests in IPRs, and in particular federal IPRs.[63] There are a number of possible variants since it would

[62] This is generally not a controversial assumption. There has been some debate on this point in respect of copyright, as many jurisdictions do not have copyright registries (see e.g. Patry at 394 ff) and problems with the description of the asset mean that copyright registries cannot be made as complete and reliable as registries for other types of federal IPRs. However, there is no active movement to abolish the copyright register in Canada, so we will not consider the point further. If the copyright register were to be abolished, then copyright would be functionally assimilated to other types of provincial IPRs for the purposes of this Report; the key feature for the approach to secured lending is the existence of the federal ownership registry, not the fact that the interests are created by federal law.

[63] We recommend that provincial IPRs should continue to be governed by provincial law, even if a federal

be possible in principle to assign different aspects of security law to different bodies of law: for example, validity might be governed by provincial law while registration and priorities is governed by federal law. These choices are addressed in more detail below. At this point we will provide a broad overview of the two main approaches.

One option would involve the explicit exclusion of security interests in federal as well as provincial IPRs from the scope of the assignment and registration provisions of the federal IP statutes and from federal control generally. In the absence of a federal secured transactions law relating to IPRs, security aspects of IPRs would be governed instead by the movables security regime in force in the jurisdiction where the debtor is located, consistently with the current provincial choice of law policy.[64] In accordance with established usage we will call this a "provincial" approach, even though this is something of a misnomer. Provincial or territorial movables security law would apply only in the case of Canadian debtors. For foreign country debtors, their home law would govern, e.g. for U.S. debtors, this would be the version of UCC Article 9 in force in the State where the debtor is located. Though the law of the debtor's location would govern security interests in federal IPRs, federal law would continue to regulate registered ownership and the owner of record in the federal registry would have priority over any security interest subsequently registered at the provincial level. Otherwise provincial law would supply the entire default secured transactions law even to the extent that any security interests

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approach is adopted for federal IPRs: see the description of the federal approach *infra* Part 6.4.1.

[64]For Quebec, see *CCQ*, article 3105, para 1 and 2. For the common law provinces and the three territories, see, e.g., NB *PPSA*, section 7(2)(a), Ont *PPSA*, section 7(1)(a)(i). Incorporeal movable property is the terminology used in the *CCQ* and generally in the civil law. The term intangible property is more typically used in the common law to denote the analogous idea although incorporeal is also understood. In this paper, the term intangible is used as most reflective of popular usage. For security in tangible movables, the *lex situs* of the collateral applies: for Quebec, see *CCQ*, article 3102; for the common law provinces and the three territories, see e.g. NB *PPSA* section 5(1)(a); Ontario *PPSA* section 5(1)(a) Note that the relevant rules in both the *CCQ* and the *PPSA*s covers choice of law for issues relating to the validity of the security right, registration and the effects of registration or failure to register. Issues of priority are not explicitly included in the choice of law reference except where they arise as an aspect of the effect of publicity. However, a recent discussion paper recommends that this omission be repaired in the *PPSA* regimes and that other aspects of the *PPSA*s conflicts regimes be clarified. See the commentary on *PPSA* ss. 5-8 in Cuming & Walsh. Such an amendment to both the *CCQ* and the *PPSA*s would eliminate any existing doubt that the designated law governs not just the priority consequences of the failure to publicize a security right and the priority of publicized security rights over unpublicized security rights, but also the priority status of the security against other competing third party claimants, including competing publicized security rights, and the interests of non-security transferees of the charged movable.

registered provincially would have priority over assignments subsequently registered in the federal system.

A second option is a federal approach to secured financing law which would remove intellectual property to which it applies from the reach of the general provincial secured transactions regimes. Federal law would govern all significant issues, including the requirements for the creation and validity of the security right, its registration and priority status, the appropriate filing venue, and the mode and manner of enforcement on default of the debtor. Federally registered interests would have priority over all provincial registered interests, including prior registered interests. However, the federal approach which we conclude would be best is also mixed in some respects: for example, it would apply only to federal IPRs; security interests in royalty payments should continue to be governed by provincial law; and provincial registration would be effective except in competition with a federally registered interest.
The next several chapters are devoted to an analysis of the advantages, disadvantages, and implementation challenges posed by each solution. But we wish to set the stage for that exercise by first explaining certain general working assumptions.

### 4.4 A Qualitative versus Quantitative Approach to Reform

Analysts sometimes justify a preference for the provincial solution on the basis of efficiency in law reform.[65] Why invest scarce law reform dollars in the development of a specialized federal

[65] For Quebec, see *Civil Code of Quebec*, Book Ten (Private International Law), Title Two (Conflict of Laws), Chapter I (Status of Property), § 2 - Movable securities. In the common law provinces and in the three territories, the principal conflicts rules have been codified in the *Personal Property Security Acts* (*PPSA*s): ONTARIO, 1976 (SO 1967, c. 73, in force 1 Apr 1976, replaced by SO 1989, c. 16, in force 10 Oct 1989); MANITOBA, 1978 (SM 1973, c. 5, in force 1 Sept 1978, see now R.S.M. 1987, c. P35); SASKATCHEWAN, 1981 (SS 1979-80, c. P-6.1, in force 1 May 1981, replaced by SS 1993, c. P-6.2, in force 1 Apr 1995); YUKON TERRITORY (OYT 1980, c. 20, 2d Sess, in force 1 June 1982, see now RSY 1986, c. 130); ALBERTA (SA 1988, c. P-4.05, in force 1 Oct 1990); BRITISH COLUMBIA (SBC 1989, c. 36, in force 1 Oct 1990); NEW BRUNSWICK, 1995 (SNB 1993, c. P-7.1, in force 18 Apr 1995); NOVA SCOTIA, 1997 (SNS 1995-96, c. 13, in force 3 Nov 1997); PRINCE EDWARD ISLAND, 1998 (SPEI 1997, c. 33, in force 27 Apr 1998); NEWFOUNDLAND, 1999 (SN 1998, c. P-7.1, in force 13 Dec 1999); NORTHWEST TERRITORIES (S.N.W.T. 1994, c. 8, in force 7 May 2001); NUNAVUT (Nunavut Consolidated Acts, in force 7 May 2001). For illustrations of the *PPSA* conflicts provisions in particular, see sections 5-8 of the Ontario, New Brunswick and Saskatchewan *PPSA*s.

substantive security law for one type of collateral when federal deference achieved through a simple choice of law rule would permit secured creditors to rely on extant general secured transactions law?

We agree that all other things being equal, the reform which is easiest to implement should be chosen. However, not all things may be equal. The goal is to produce the most efficient cost-effective reform, not from an immediate term implementation perspective, but from a long term operational perspective. It would not make sense to choose a reform path that is clearly second best merely because it is easiest to put in place in the short term.

We also need to be careful in defining our point of comparison. We have already seen that the ownership, assignment and registration provisions of the federal intellectual property statutes require reform if they are to enable secured creditors to verify a prospective debtor's title with any degree of confidence. As we will see, federal law would need to be reformed and modernized even if the provincial approach were adopted, or the weak link posed by the current deficiencies in the federal system would undermine the advantages of the modern provincial systems. The need for complementary reform of the federal registry systems must be keep in mind when comparing the ease of implementation of the provincial and federal approaches.

Of course, in deciding the ultimate direction of reform the practicality of implementing that reform must be taken into account. Nonetheless, in comparing the two alternatives, we need to think in terms not of the existing law and registry system but of the best feasible version of each alternative. The final choice of solutions requires an assessment of the relative merits of each approach combined with the relative difficulty of implementing each. A somewhat imperfect solution that can be implemented at minimal cost may be superior to a perfect system that requires a complex implementation process. The ultimate decision requires to some extent a value judgment that is beyond the scope of this Report, although we hope to provide the pertinent decision points to enable that value judgment to be made. .

## 4.2 Constitutional Bases for Reform Alternatives

Doubts are occasionally raised with respect to the scope of federal constitutional authority over secured transactions covering federal IPRs. In our view, such doubts are misplaced. We say this because of the unquestionable federal power over issues relating to ownership and the transfer of ownership of copyright, patents, and federal trademarks. The ability to grant security is one of the bundle of rights associated with ownership. The grant of security potentially results in an involuntary transfer of ownership should the debtor default and the secured creditor seek to exercise its enforcement powers against the charged property. In other words, authority over ownership and its transfer necessarily includes authority over a security transfer or hypothecation of ownership. In order to find that the federal government is not competent to legislate in respect of security in federal IPRs, we would need to find that it is necessary to draw a constitutional line between ownership interests and security interests in the same item of intellectual property. In later sections of the report we show why that position is not defensible based on a constitutional policy analysis of the justifications for the federal IP power.

At the same time, we do not wish to suggest that the provincial legislatures are incompetent to legislate in respect of security in intellectual property rights as an aspect of their general legislative authority over property and civil rights. By virtue of federal paramountcy, provincial laws of general application are rendered inapplicable only to the extent that federal law governs the particular issue. However, in the absence of positive federal law, there can be no constitutional objection to the application of the provincial security regimes. Moreover, unless there is a direct conflict, the double aspect doctrine would support the concurrent application of both federal and provincial law.[66]

In any event, under a provincial solution, the basis for the application of provincial or territorial

[66] See e.g. Mercier & Haigh at 77: “Both the federal intellectual property legislation and the respective provincial PPSAs are valid under their own jurisdictions and, if challenged would not fail the first part of the test.. . .The most that could be said is that the security provisions under the PPSA legislation and the registration provisions under the federal intellectual property statutes have a double aspect to them,” at generally *ibid* at 72ff.

law would be (as explained later in more detail) a federal choice of law provision expressly deferring to the law of the debtor's location. The constitutional jurisprudence in the maritime field firmly establishes that the federal Parliament has authority over the choice of law aspects of any subject matter within its constitutional competence, and is also empowered to referentially incorporate other bodies of law as federal law. Either or both of these theories provides more than sufficient constitutional support for the choice of law solution, from both the federal and provincial/territorial perspectives.

## 5 The Provincial Approach

### 5.1 Introduction

As already discussed, under the "provincial" approach security aspects of federal IPRs (and, of course, provincial IPRs) would be governed instead by the movables security regime in force in the jurisdiction where the debtor is located. In the case of Canadian debtors, any security interests registered provincially would have priority over assignments subsequently registered in the federal system. Similarly, the rights of a judgment creditor vis-a-vis a secured creditor or assignee would be determined by provincial law, so that where provincial law so provides, provincial registration by a judgment creditor in the provincial security system would be effective against subsequent assignees and secured parties. But at the same time the integrity of the federal ownership registry must be maintained. To do this, a interest registered provincially must be subordinated to a prior federally registered assignment.

The most obvious advantage of the provincial alternative is that its implementation would involve minimal federal law reform resources. It also has the advantage of preserving stability in the law. Existing provincial law refers issues relating to security in intangibles to the debtor's home law. Consequently, this solution would respect existing provincial legal policy thereby ensuring that intangible assets in the form of intellectual property are governed by the same secured transactions law that applies to other intangible collateral. The most obvious disadvantage of the provincial solution is that it separates the substantive legal regime governing the grant of security in federal IPRs from that governing their ownership and assignment. This Part first addresses some details of the implementation of the provincial approach, and then turns to problems created by this severance between ownership and security interests.

## 5.2 Implementation of the Provincial Approach

### 5.2.1 **Need for Federal Choice of Law** Rule

It would be possible to implement the provincial approach with federal legislation making it clear that the federal registration requirements had no application to interests which were in substance security interests. The law of the debtor's location would then govern by default. However, it would be preferable to implement provincial alternative be federal enactment of a choice of law rule deferring to the law of the jurisdiction where the debtor is located. If articulation of the choice of law rule were left to provincial or territorial law, there is a risk of non-uniformity at least at the level of detail (e.g. definition of debtor's location), leading to the possibility that the applicable law will vary according to the forum in which litigation is pursued.[67] This risk is not acceptable for federal IPRs because, as we shall see, the provincial solution is intended to work in tandem with a limited degree of federal substantive law reform.

### 5.2.2 Resolving Priority between a Secured Creditor and an Assignee of the same IPR

As we have noted, a security interest registered provincially must be subordinated to a prior

[67]Note that the Secured Transactions Law Reform Committee, operating under the auspices of the ULCC commercial law strategy, has recommended greater uniformity in choice of law policy in its 2002 report. But even if these recommendations are eventually implemented, there would still be some differences at the level of detail. Note also that even if perfect uniformity were achieved, a federal rule would be needed for the purposes of resolving any dispute litigated before the Federal Court. This is because, for Federal Court jurisdiction to exist, there must be an existing body of federal substantive law to govern the claim that is the subject of the dispute before the Court. For present purposes, we assume that the referential incorporation of other law through a federal choice of law rule would be sufficient to meet this requirement. However, we reserve for the final version of the Report the question of whether this assumption is correct and if so whether Federal Court jurisdiction would be useful or desirable.

federally registered assignment. How is this rule to be implemented? Should the law of the debtor's home jurisdiction supply the default priority rule or should there be a federal substantive rule for this particular issue?

The difficulty with the provincial solution is that the general priority rules of the debtor's home jurisdiction typically are not designed to cover this kind of dispute. Suppose, for instance, that the debtor is located in New Brunswick so that the New Brunswick PPSA governs the perfected and priority status of the security interest. The NB PPSA priority regime, like that in effect in the other common law provinces, orders priority between a secured creditor and a transferee according to whether the transferee acquired its interest before or after the security interest was publicized by registration. If before, the transferee prevails unless he or she had actual knowledge that the debtor had already granted security. If after, the secured creditor prevails. The result under the CCQ is broadly similar except that the transferee would prevail against an unregistered security, even if the transferee was aware of the existence of the security interest at the time it acquired its own interest.

These provincial priority rules were designed on the assumption that the transferee's interest, unlike that of a secured creditor, is not required to be publicized to acquire third party effect. The rules are not designed to accommodate a situation where both interests are subject to a publicity requirement, albeit under different registry regimes enacted at different levels of government. In the situation posited here, application of the law of the debtor's location to supply the default rule would preclude a secured creditor from being able to rely on a search of the federal IP registry to assess its priority status as against a competing assignee. The secured creditor would be bound by prior unknown assignments of which it has no knowledge or means of acquiring knowledge, even if the policy recommendations outlined earlier to strengthen the federal registry regime for assignments were implemented.

The most logical solution to this problem would be to supplement the federal choice of law rule deferring to the debtor's home law with a substantive priority rule ranking the assignee and the secured creditor according to the respective dates of registration of their interests in the federal IP registry and in the movables registry of the jurisdiction where the debtor is located. However, in the case of a foreign debtor located outside North America, the applicable law may not require or even enable registration of the security interest. As a matter of practical implementation, it would not therefore be possible to state the rule as a pure first to register rule. Rather, to accommodate foreign debtors, it would need to be crafted along the following lines (borrowing from the PPSAs): "An assignee of an IPR acquires the right subject to a security interest granted by the assignor if the assignment is registered in the federal IP registry after the secured creditor has complied with all requirements imposed by the law of the jurisdiction where the debtor is located to render the security effective against third parties."

## 5.3 **Search Burden Problems Posed by Chain of Title Considerations**

### 5.3.1 **General**

If the rights of assignees of federal IPRs are to be made subject to prior security interests acquired under the law of the debtor's location, it follows that prospective assignees carry the burden of determining whether or not the IPR in which they are interested is validly encumbered by a security interest under that law. If the debtor is an assignee or licensee, or if the relevant work is built on pre-existing creations, the prospective assignee faces the further risk that the IPR was encumbered by a security interest granted by a predecessor in title to the immediate apparent owner.[68] Consider the following hypothetical.

> *Debtor, located in Prince Edward Island, grants a security interest in its present and after acquired property. Secured Creditor registers notice of its security in the PEI Personal Property Registry. Without Secured Creditor's authority, Debtor assigns its IPRs to B1, located in Ontario. B1 registers its assignment in the relevant federal IP registries, and then assigns the IPRs to B2 who also registers federally.*

[68] For a detailed analysis in a U.S. context, see Brennan, (2001a), (2001b).

Unless the secured creditor is protected in this scenario, its security would be capable of being lost through the unilateral wrongdoing of the debtor in disposing of the collateral without the secured creditor's authority.  But if later assignees in the position of B2 are to take subject to a security granted by a predecessor in title, it will not be sufficient for them to search the registry in the jurisdiction in which the immediate assignor is located, here Ontario.  To protect themselves, they will need to identify all assignees in the historical chain of title, ascertain the jurisdiction in which each was and is now located, and then determine whether an effective security interest was granted by any of them according to the law of their respective home jurisdictions.

The problem is not simply one of balancing the information burden imposed on assignees of IPRs against the goal of facilitating secured lending against IPR collateral.  Prospective secured creditors lending to B2 in the above scenario would face exactly the same inquiry burden in order to ensure that the relevant IPR was not already encumbered by a security interest granted by a predecessor in title.

### 5.3.2 **Foreign Debtors**

The problem is exacerbated when an owner in the chain of title is located in a foreign jurisdiction.  Consider for example the large number of Canadian patents issued to U.S. patentees.  In the case of a foreign country debtor (or a foreign country predecessor in title), application of the debtor location rule would mean that the secured transactions law of a foreign country would apply to determine the validity of a security right granted in Canadian intellectual property rights, the manner and mode of publicizing it, and its priority ranking against third parties.  This means that foreign registries may need to be searched in order to discover security interests affecting Canadian IPRs.  Any financier seeking to take Canadian patents belonging to a U.S. debtor as security would be required to search the state Article 9 register of the state in which the debtor was located.  The same is true if the lender was dealing with a Canadian debtor who had taken an assignment of the patent from an original U.S. owner.

Worse, many foreign countries do not operate general encumbrance registries of the kind established by the provincial and territorial secured transactions regimes in Canada. This means that any encumbrances granted by the foreign debtor may be entirely undiscoverable. A party dealing with the Canadian IPRs in such a case could do no better than to rely on warranties and representations. It might be difficult to obtain satisfactory warranties if the foreign owner was not the debtor but a predecessor in title to the current owner.

It is true that most countries have established intellectual property registries to accommodate the registration of security rights in addition to ownership transfers in intellectual property, with the priority of the security right then determined wholly or partially in accordance with the order of registration.[69] However, these registries are territorially confined, like the federal Canadian registries, to intellectual property rights to be exploited within the borders of the particular country.[70] They are not designed to accommodate the registration of security in Canadian intellectual property rights.

The remainder of this section considers possible structural responses to this problem.

### 5.3.3 **"Gateway" Searching**

In the United States context, a report by the Franklin Pierce Law Centre ("FPLC Report"), commissioned by the USPTO[71] proposes a one-stop "gateway" approach in which a single query

[69]For an illustrative list of national registries and a summary description of their scope, see Brennan (2001a).

[70]The multilateral Madrid and Hague Systems constitute an exception. Under these systems, a trademark or industrial design owner in one of the member states can obtain protection for the mark or design in some or all of the other members by filing a single international registration with WIPO. These systems also accommodate the registration of changes of ownership as well as renewals (but not security interests). For further details, visit the WIPO web site: www.wipo.org.

[71]The FPLC Report is summarized in Ward & Murphy. It has not yet been formally accepted by the USPTO.

at a meta-search site would automatically query all the state Article 9 security interest registries and all the federal intellectual property ownership registries and return a single report. While the databases would be separate, in practice it would appear to the user as though only one registry is being searched.

Would construction of a common entry portal of this kind suggested resolve or at least alleviate the inquiry burden on assignees and secured creditors who contemplate taking security in a Canadian IPRs? Provided all the owners in the chain of title were located somewhere in Canada, this solution would avoid the need to determine the precise provincial or territorial location of each debtor in the chain of title, and to search each registry separately, since all registries would be automatically queried. (The fee implications of this approach would need to be worked out carefully, since querying all thirteen registries for every owner in a long chain of title could be very expensive if the normal province-by-province tariffs were to apply. Presumably a revenue neutral solution would be possible, since increased volume queries would compensate for reduced fees for gateway searching.)

Though the gateway approach would alleviate search problems in the provincial approach, the simplicity and efficiency of the common gateway solution should not be exaggerated. The authors of the FPLC Report acknowledge that it will be necessary to search the state security registries by debtor name for all predecessors in title to the immediate debtor whose names appear in the federal registry, [72] but they imply that this process will be easy because the gateway

[72] This Report is not as clear as might be desired on this point. The entirely of the relevant discussion is as follows: “This integration [a meta-site or unified federal security interest registry] will make it possible to efficiently search UCC filings on grantors and grantees of record who show up under the various federal property numbers.” Part VI.A.3, p64

approach allows a one-stop search of all databases.[73]

[73]Presumably owner name rules under the federal IP Acts would be amended to correspond to the state UCC rules, although the Report does not address this point.

While we agree that a common portal would provide a one-stop searching venue, it is incorrect to suggest that it would do away with the need for multiple searches. An initial separate search of the federal IPR registries will be needed to establish the identity of the successive owners in the chain of title, followed by multiple separate searches of the provincial security registries according to the name of each owner in the chain of title. It would also be necessary to compare the timing of the various registrations, even in a purely Canadian context. For example a financing statement disclosing a general security interest might not have been registered until after the debtor or a predecessor in title had assigned the IPR to another.[74]

A further complication is added by the fact that in Canada there is considerable variation in the rules and policies adopted by the different provinces and territories on how the correct name of the debtor is to be identified for registration and searching purposes. The lack of uniformity is greatest with respect to individual debtors; if we assume that most debtors who charge their IP collateral are enterprises rather than individuals, the existing differences may not prove too problematic in practice. On the other hand, differences also exist at the corporate name level and given the exactitude required in searching an electronic data base, the practical impact of this problem on the feasibility of the gateway solution should not be underestimated. Moreover, without uniform federal/provincial name rules (which is inevitable if provincial name rules are not themselves uniform), a security interest might be validly registered provincially against the name of a predecessor in title and yet be undiscoverable by a search using the style of owner name specified by the rules of the federal ownership registry. It is not clear how the searcher can avoid this problem. If a searcher wished to search multiple jurisdictions according to the name of its immediate debtor, it could search each jurisdiction by the name of that debtor defined according to the rules of the jurisdiction in question. But in the case of the predecessors in title, the searcher has no more information than is disclosed by the federal ownership registry. The searcher might guess as to variations that would correspond to the debtor name under the rules of

[74] This problem does not arise in the current provincial system in which a security interest registered against a predecessor in title to the current owner is not discoverable except for those types of property for which asset indexing is required, in which case a subsequent interest taker takes clear unless the security interests was registered against that particular asset.

the various provincial systems, but this would result in considerable additional cost, since the search criteria would require judgment, and there would in any event be irreducible uncertainty.

This problem would be reduced if uniformity in debtor names rules, between provincial security registries *and* the federal ownership registry, could be achieved. This might be a significant hurdle given that the current provincial regimes have not managed to achieve uniformity, even among the PPSA jurisdictions.

Finally, a purely Canadian gateway would not affect the search problem in the case of foreign debtors. A prospective secured creditor or assignee would still have to ascertain the location of any owner in the chain of title who is located outside of Canada and make inquiries as to possible outstanding security interests arising or registered under that law.

#### 5.3.4 **Debtor Name vs Asset Specific Registration-Search Criterion**

The discussion of the common gateway approach to this point has assumed that registrations and searches for security granted in IP collateral in the provincial registries would be conducted according to name of the potential grantor of the security. But IPRs are already indexed by individual asset identifiers in the federal ownership registries, and asset indexing is not unknown to the provincial movable registries, which employ it for a restricted class of serial numbered goods.[75]

The adoption by the provincial registries of asset indexing for IPRs, using the federal IPR registration number, would alleviate the problems identified above stemming from the lack of uniformity in the debtor name rules of different jurisdictions. Asset indexing would also

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[75] There is jurisdictional variation as to which goods must be described by serial number. All the PPSAs and the Civil Code of Quebec require specific serial number description for road vehicles. The non-Ontario PPSAs also require serial number description for a number of other categories of goods. Serial numbered goods do not have to be described by serial number when held as inventory, so it would be more accurate to refer to "serial numbered equipment or consumer goods" to mean goods which must be described by serial number in order to perfect a security interest. The phrase "serial numbered goods" will be used in the interests of brevity. There is also jurisdictional variation regarding terminology.

eliminate the need to conduct multiple searches according to different debtor names (although it would still be necessary to conduct multiple searches according to each individual item of IP).

Unfortunately, there are a number of impediments to this proposal.

First, it is not a feasible solution for security in copyright. Copyrights do not have to be registered federally to come into existence. To require the federal identification number to be registered in order to effect a provincial security registration against a debtor's copyrights would effectively force would-be debtors to go to the expense of registering their copyrights in all possible works before being able to grant an effective security in them. The burden would be particularly excessive for works of a kind that are continually evolving e.g. software. Moreover, even if this were considered worthwhile from a cost benefit analysis, copyrights cannot be reliably identified by reference to their individual federal registration number because the same work may be registered and described by different names in the federal registry. Consequently, a search would still have to be made against debtor name.

A second major difficulty is that asset indexing, even if restricted to patents and trade marks, would preclude the registration of an effective security interest in a debtor's future IPRs (because they could not be identified uniquely) or in generic categories of IPRs (because the cost and expense of entering an individual descriptor for each item within a generic portfolio of IPRs would likely outweigh the benefit). It is because of these considerations that asset indexing is restricted to types of property which tend to be relatively durable and individually valuable: land and certain classes of personal property such as automobiles. In other words, asset indexing tends to be used only when the risk to subsequent transferees is highest and the burden relative to the value of the collateral is lowest. Intellectual property falls in an uncomfortable middle ground. Certainly, some intellectual property rights, such as a pharmaceutical patent on a major drug or the copyright on the flagship product of a software company, are individually very valuable. But other IPRs, such as the multitude of minor patents held by any firm with significant R&D may not be particularly valuable relative to the size of the loan and would be more efficiently charged *en masse* as simply “all IPRs” or even included as part of a charge on all the debtor’s “present and after acquired property.

It is unclear to us whether it would be possible to draw even a rough dividing line between types of IP that might be efficiently indexed individually and those where a generic description would be commercially preferable. A middle ground solution would be to require registration by asset description for the security to be effective against subsequent secured parties or assignees. This would allow any person dealing with a specific IPR to be sure that they would not be subject to any prior undiscoverable interests, leaving it for the secured party to use its own judgment as the value of the collateral in choosing whether to register by asset description.[76]

At the end of the day, we are not convinced that asset-indexing for security in IPRs is worth pursuing. The main advantage is to avoid the need to achieve interprovincial and federal/provincial uniformity in debtor name rules, and to alleviate the need for multiple debtor name searching back through the chain of title. While interprovincial uniformity as to the appropriate asset identifier should not be a problem for IPRs, uniform adoption by all provinces is likely to be since it would require a significant redesign of the existing hardware and software. Yet if the possibility of asset based indexing for IPRs was not uniformly adopted, the benefits would be significantly reduced. If there were even one non-compliant jurisdiction, it would be necessary to conduct a full chain of title search, determine if any predecessor in title in the chain was located in the non-compliant jurisdiction, and then conduct a name based search in that jurisdiction.

Even more importantly, even if uniform adoption were achieved among the Canadian secured transactions regimes, this would not assist in the case of a foreign country debtor or antecedent

[76] A problem with this approach is that a debtor in difficulty could milk the assets by granting security interests to a subsequent secured creditor who registered by asset description. This problem would be somewhat worse than in respect of the present class of serial numbered goods, as there is would be no strict cut-off below which it would not be necessary to register (ie the class of IPRs is not closed in the same way that the class of serial numbered goods is closed. It is a judgment call as to whether the value of the IPR is too low to be worth registering, and a determined debtor could always grant interests in IPRs which fell below the line.

owner whose home jurisdiction may not even provide for registration, and even if it did, would not provide for indexing according to the registration numbers assigned by a foreign intellectual property registry.

## 5.4 **Reformed Federal Registry**

We noted in an earlier Part[77] that a provincial approach would require reforms to the federal registry system. Now that we have seen in more detail how a provincial system would operate, we repeat the point for emphasis.

The provincial security systems themselves are modern and efficient. Accordingly, one of the main advantages usually associated with a provincial system is that it would allow an effective system for taking security interests in IPRs without the need for extensive reform to the antiquated federal registries. But the above discussion shows that this assumption is not well-founded. The federal ownership registries are an integral part of the provincial system, since chain of title searching through the federal ownership registry is necessary to establishing good security in IPRs even under the provincial approach. That means that without reform to the federal ownership registries, these registries will remain a weak link in the system that will negate many of the advantages associated with taking security under the modern provincial systems.

Thus, significant reform of the federal registries to allow legally reliable, up to date, on-line searching of the federal ownership registries, including full chain of title for all IPRs (that is, grantor/grantee searching), is important. Otherwise it will not be possible to take a fully protected security interest in a debtor's federal IPR without the cost and delay of a search at the CIPO offices in any case where the debtor is not the original owner of any of its IPRs.

Legal change is also desirable. As we have seen, at present the form of the security agreement is

[77] *Supra* Part 3.3.

important with respect to registration in the federal system. A reformed system would adopt the substance over form approach which is used in the provincial systems. This should not be controversial. Also, as we have noted if uniformity at the provincial level in debtor name rules were achieved then the same rules should also be implemented in respect of ownership interests at the federal level.

### 5.5 **Inconsistency of Choice of Law Rule with Other Jurisdictions**

As a final point, we note that to apply the law of the debtor's location is inconsistent with the general territorial principle[78] that pervades intellectual property law. Despite its intangible nature, intellectual property has historically been treated as being just as territorially fixed as real estate. There is no universal concept of an intellectual property right. Even though international conventions may impose international minimum standards, intellectual property rights still comprise a bundle of nationally-determined rights, the application of which is confined to the territory where the property is exploited. It follows that, as with land, intellectual property rights within each country are governed by the national law of that country.[79]

The territoriality principle that pervades intellectual property law, and its analogy to land, suggests that the location of the collateral as opposed to the location of the debtor or the current owner is the more appropriate connecting factor for property dealings in intellectual property, whether by way of sale or security. The relevance of the territorial principle here is not purely conceptual. It accords with approach taken by most countries, under which the law governing the

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[78] See e.g. Austin.

[79] See e.g. Eugen Ulmer, *Intellectual Property Rights and the Conflict of Laws*, English trans., Deventer, Kluwer, 1978, Eugen Ulmer, "General Questions – The International Conventions", Ch. 21 in *International Encyclopedia of Comparative Law*, Vol XIV *Copyright and Industrial Property* (Eugen Ulmer, ed.) ( J.C.B. Mohr (Paul Siebeck) Tubingen and Martinus Nijhoff Dorderecht, Boston, Lancaster: 1987); Graeme Austin, "Private International Law and Intellectual Property Rights: A Common Law Overview" (paper prepared for WIPO forum on private international law and intellectual property, Geneva, January 30 and 31, 2001); Fritz Blumer, "Patent Law and International Private Law on Both Sides of the Atlantic" (paper prepared for WIPO forum on private international law and intellectual property, Geneva, January 30 and 31, 2001); Martin Wolff, *Private International Law*, 2d ed (Oxford: Clarendon, 1950) at 547-48; James J. Fawcett and Paul Torremans, *Intellectual Property and Private International Law* (Oxford: Clarendon Press, 1998).

sale and grant of security in IPRs is integrated into a unified territorially-confined registration-based legal regime. Although the matter is being reconsidered currently, this is the current rule in the United States with respect to copyright as a result of a Federal Court ruling in the famous *Peregrine* case. It is true that reform efforts are underway in that country to return issues relating to security in copyright to the purview of state law, in particular Article 9. However, the debate is still controversial and even the Article 9 centred reform efforts contemplate close coordination with the federal law on IP ownership and its transfer. More importantly, Article 9 in the United States, while predicated on state enactment, is *de facto* national law since the identical version has been enacted by virtually every state. The same coast to coast to coast *de facto* uniformity does not exist in Canada, of course, with the result that the rights of secured creditors and third parties in respect of security taken in the same kind of federal IPR will fall to be determined under a federal deference approach by a different set of substantive secured transactions rules, depending on the jurisdiction in which the debtor is located.

This means that even if the provincial approach is adopted in Canada, the debtor location rule would be confined to Canadian IPRs. In view of the prevalence of the territorial principle internationally, a Canadian debtor granting security in its U.S. or European IPRs would not be able to rely in practice on its home secured transactions law. Any dispute involving foreign IPRs is apt to be adjudicated in the country where the IP rights are sought to be exploited and the courts of that country will apply their own territorial choice of law solution, a s opposed to the debtor location rule. The result is that other jurisdictions are unlikely to adopt a similar rule, with the result that foreign debtors could publicize an interest in Canadian IPRs with a foreign registration (or without registration, if that is what their law allowed) while a secured creditor lending to a Canadian debtors who held foreign IPRs would not have the similar benefit of a single registration, but would be required to register in the foreign jurisdiction.

5.6 **Summary and Recommendations**

To this point we have seen that the existence of a federal ownership registry makes the major forms of federal IPRs different from traditional personal property and more akin, in some ways, to land. The existence of an ownership registry complicates the search burden for prospective secured creditors and assignees as compared to traditional personal property, because of the need to search up the chain of title to ensure a clean chain of title including protection against the risk of a grant of security by a predecessor in title to the immediate debtor.

Under a provincial approach, this chain of title search is also more complex than for land because the ownership registry and the security interest registries are separate, because the chain of title search may require multiple searches to be conducted in multiple jurisdiction, and because no security registry may exist where the debtor or predecessor in title is from a foreign country.

The need to search for antecedent security interests granted by predecessors in the debtor's chain of title to the immediate debtor adds to the search burden in respect of IPRs used as collateral under a provincial strategy The practical extent of this additional burden is not clear. It depends on the extent to which the IPRs used as collateral originated, by assignment or licence, with someone other than the debtor. This is likely to depend on the particular industry.

A common gateway approach to searching the provincial security registries and the federal IP registries would substantially reduce this search burden. However, the remaining search burden would be significant. If complete uniformity in debtor name rules among provinces and between the provincial and federal registries is lacking a fully reliable chain of title search may not be possible. Achieving this uniformity may be a significant barrier to implementation.

Further, the common gateway solution would not assist to secured creditors and assignees in verifying the risk of security having been granted by an owner in the chain of title who is located outside of Canada. The additional inquiry burden and risk this imposes would vary according to whether the secured transactions regime in force in that particular jurisdiction operated an encumbrance registry of the kind in place in the Canadian provinces and territories.

Asset-based indexing of IPRs would do away with the need for interprovincial and federal uniformity at the debtor name level, but would depend on uniformity of adoption by the various provinces and territories, which is by no means guaranteed. Moreover, this approach would have a negative impact on the ability of debtors to grant security in generic categories of IPRs through a single agreement and a single filing. For these reasons asset-based indexing of IPRs at the provincial level is not recommended.

## 6 The Federal Approach

### 6.1 Introduction

Under a federal approach reformed federal substantive law would govern all significant issues relating to federal IPRs, including the requirements for the creation and validity of a security right, its registration and priority status, the appropriate filing venue and the mode and manner of enforcement on default of the debtor. The key difference relates to registration and priority: under a provincial approach, an interest registered federally would be subject to any prior provincially registered interest. In contrast, under a federal approach, any interest registered federally would not be subject to any interest registered elsewhere.

The advantages and disadvantages of a federal approach are in some ways the converse of those of the provincial approach. The main disadvantage is that significant reform of the federal registry system is needed. (Though, as we have seen, significant technical reform to the federal registry is required even under the provincial approach.) A major advantage is that the unified federal jurisdiction eliminates the choice of law and chain of title search problems which dominated our analysis of the provincial approach. The advantage here is not simply that searching would be simplified because only one registry would be searched. More importantly, because federal law, not the law of the debtor's location, would govern, the problem of difficult to search or undiscoverable interests granted by foreign debtor's would be eliminated.

Three questions need to be dealt with in the context of a federal approach. First, will the system be a pure federal approach in which federal registration is the exclusive means of publicizing a security interest, or a mixed approach in which provincial registration retains some role? Secondly, what reforms are needed to the federal registration system? Finally, what is the scope of the federal system: for example, are security interests in unregistered copyright or royalty payments to be governed by federal or provincial law? The remainder of this Part deals with these questions in turn.

## 6.2 **Pure or Mixed Approach** ?

### 6.2.1 **Recommended Approach**

Under a provincial approach, an interest registered federally would be subject to any prior provincially registered interest. In contrast, under a federal approach, any interest registered federally would not be subject to any interest registered provincially. Thus to achieve the maximum degree of protection it would be necessary to register federally.

From this starting point, there are a number of variants. The main issue is whether the federal system would be the exclusive means of perfecting an interest in IPRs. In a pure federal approach, such as that established in the U.S in respect of copyright according to the notorious

*Peregrine* decision, any security interest which is not registered federally would be entirely ineffective against third parties. In what is sometimes referred to as a "mixed system" provincial registration would be effective against any party who had not registered federally, including any judgment creditor and the trustee in bankruptcy.

In our view there is no advantage to a pure federal approach. The argument made by Judge Kozinski in *Peregrine* was that a pure federal registration system would facilitate searching as all relevant interests would be registered in a single venue. But this is also true in a mixed system. Since federal registration trumps any prior provincial registration, any person intending to register federally need only search federally. Any interests which were only registered provincially could be safely ignored. Accordingly, we recommend that the federal approach adopt this "mixed" system. We will assume a mixed system in the discussion which follows.

We noted earlier that qualification based on actual knowledge in the federal registry system should be abolished no matter what approach is adopted. It bears emphasizing here that it is essential to the "mixed" federal approach that the holder of a federal interest will have priority over any security interest which is only registered provincially, even if the federally registered interest holder has prior actual knowledge of the provincial registration. Actual knowledge might be very common as a result of a search of the provincial system, and if this knowledge were to affect priority the mixed federal approach would be fatally undermined.

### 6.2.2 **Alternative Mixed Approach**

In principle a mixed system in which the law governing issues other than priority, such as validity, attachment and enforcement, would be left to the law of the debtor's location. (This approach would have sub-variants depending again on whether a provincially registered security interests was ineffective for all purposes or only in a competition with a federally registered interest.) Our view is that this type of mixed approach should be rejected in favour of the holistic approach described above in which all issues would be dealt with by federal law. The holistic approach would not be significantly more difficult to implement. Most of the major system reforms are required to accommodate the basic priority rules, and addressing validity, enforcement and similar issues would be primarily a matter of drafting. There would also be some economies in addressing the non-priority matters federally. For example, specific enforcement procedures might be useful for IPRs and federal law would avoid the need to amend the provincial laws in this respect. It would also allow more effective integration of enforcement and title issues, as it would be straightforward to provide for transfer of ownership as an enforcement mechanism. This is particularly relevant in the case of foreign debtors. If enforcement mechanisms were left to foreign law, then what would be the effect of a foreign judgment ordering the transfer of ownership in a Canadian IPR? In the Canadian context uncertainty on this matter could be resolved through federal legislation recognizing the validity of the provincial enforcement process, but a solution along these lines in respect of foreign debtors would be much more difficult. Perhaps none of these objections is overwhelming, but once priority issues are allocated to federal jurisdiction, there is no positive reason in favour of leaving validity, enforcement and other such matters to the law of the debtor's jurisdiction.

## 6.3 **Reforms to the Federal Registry System**

### 6.3.1 **Basic Reforms**

We have seen that even in a provincial system the federal register would need to be reformed to allow legally reliable, up to date, on-line searching. Debtor name rules would also need to be specified to enable reliable searching. The same basic reforms would needed in a federal system.

### 6.3.2 **Notice Filing**

There is some ambiguity in usage as to whether notice filing is simply opposed to document filing or automatically implies perfection of after-acquired property. We use it in the former sense. The superiority of a notice registry for security interests generally is a principle that has been widely accepted in Canadian law.  All the provincial movables registries and the federal Bank Act registries are notice registries and the same model has been proposed for security interests in land.[80]  There is no reason why it would be any less advantageous in respect of a registry for security in intellectual property.[81]  Accordingly, we recommend and will assume in the remainder of this Report that notice filing would be adopted in any federal registry system that might be established for security in intellectual property rights.

### 6.3.3 **Integrated or Separate Charge and Ownership Registries**

The federal approach has several possible implementations which vary according to degree of unification of the federal IP registries.  Perhaps the most obvious approach would use the existing separate federal IPR registries for registration of security interests as well as ownership interests; that is, all copyright related interests would be filed in the copyright register, etc.  Alternatively, it is sometimes suggested that any federal system for registration of security interests should be a unified security interest registry for all types of IPRs.[82]  This alternative itself can be further broken down.  The current separate federal IP registries might be maintained as ownership registries only and a new separate federal IP security interest registry would be established. Another option would be to integrate all existing and proposed registries for the various IPRs into a single "grand unified" IP registry which would provide a single venue for registration of all types of interest in any type of IP.  This option would avoid some of the legal problems with coordination of separate registries, but it might well present significant technical hurdles, particularly in view of the different search fields which must be maintained for the different kinds of IPRs.

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[80] See Siebrasse and Walsh, *Proposal for a New Brunswick Land Security Act.*

[81] The only suggestion to the contrary in the prior research is found in the Statement of Marybeth Peters, U.S. Register of Copyrights, before the Subcommittee on Courts and Intellectual Property on Recordation of Security Interests in Intellectual Property 106th Congress, 1st Session June 24, 1999.  Peters' objections, which are based on lack of information in the public record, are not specific to secured lending in respect of IPRs, but apply to any form of secured lending.  In view of this we believe that experience with notice financing under the PPSA and Article 9 demonstrates conclusively that her objections are entirely without foundation.

[82] Cuming**

In our view this issue is not central. The advantage to either type of unified federal registry is that it would provide a 'one-stop' search and registration venue. But this can equally well be achieved using a "gateway" approach to searching multiple registries in which a single search at an electronic "meta-site" would automatically be routed to all relevant registries and with the results returned as a single report. Thus to the user the system would appear to have only one registry, no matter how the registries are configured technically. As we have seen in the discussion of the provincial system, one impediment to the effective implementation of the gateway concept is the need for uniform debtor name rules. This requirement should not present any difficulty in respect of the various federal IP registries given that all are within the federal jurisdiction. There is no substantive reason for different name criteria for in these registries and if they are modernized it should be very straightforward to ensure that the same criteria are implemented in respect of each registry. Once this is accomplished the legal problem is solved and the issue of whether the federal IP registries should be unified either wholly or in part turns into a purely technical question of whether it is easier to build a unified gateway or an entirely new registry.

Since the resolution of this issue is not crucial, for convenience in characterizing the federal position in our framework we will adopt the simplest approach, which is that separate registries would be maintained for different types of IPRs and both security interests and ownership interests would be registered in the appropriate IP registry. We emphasize that we are also recommending and assuming that the separate federal registries would have uniform debtor name rules so that 'one-stop' gateway searching and registration could be easily implemented.

### 6.3.4 **After-acquired Property and Asset Indexing**

Perhaps the single most trenchant criticism of the federal approach is that, because the federal registries are asset based, the federal approach would prevent lenders from effectively taking security in after-acquired property. We agree that this is a serious concern, but we believe it can be addressed with proper registry design.

Asset indexing minimizes the search burden on subsequent grantees, since a single search reveals all current interests in that asset. The difficulty with asset indexing is that it impedes granting security interests in after-acquired property. But a technical solution to this problem is possible in an appropriately designed unified ownership/security interest registry system. It should be possible to provide that when a new asset is registered in the debtor's name the system would automatically search for security interests also registered against that name and any such interest would automatically be registered against the specific asset.[83] We can refer to this as a system with automatic cross-registration. To implement such a system debtor name regulations would have to apply to ownership interests registered in the ownership registry as well as to security interests. Further, a specific check box on the financing statement would be needed to reflect whether the security agreement has an after-acquired property clause. The system must not register a security interest which does not have an after-acquired property clause against the debtor's after-acquired property. A specific field for this purpose on the financing statement, similar in principle to the separate field for serial number descriptions, would be necessary to allow this approach to be implemented by a computerized system.

If implemented, such a system would greatly reduce the burden of providing specific asset descriptions in the initial registration as well as allowing automatic perfection of interests in after-acquired property. The demands on the system are more severe in the context of automatic perfection of after-acquired property than in the case of initial registration. On initial registration the automatic cross-indexing capacity would serve as an aid to the registrant in identifying property belonging to the debtor and in ensuring that no errors are made in the asset descriptions. Inexact match problems could be dealt with directly by the registrant.

Inexact matches would pose a more significant problem in the context of after-acquired property.

[83] That is, either owner name or asset description can be used as search criteria, and a search of owner name will reveal all assets belonging to that owner, and conversely, a search by asset description will reveal the owner. This approach is based on Siebrasse & Walsh, "A Proposed Land Security Act for New Brunswick", s.15 Priority of Judgment Creditors, p.51 "Priority in after-acquired lands".

There are two concerns.  First, what would happen if ownership of the newly acquired asset (e.g. a patent for a new invention) was registered in a name which was not the correct name (as prescribed by regulation) of the newly registered owner?  Secondly, what would the system do with security interests registered against names which are inexact matches to the name under which the new asset is registered?

The first problem is significant because a debtor might intentionally register a newly acquired property under a name other than the debtor's correct legal name precisely in order to avoid having prior security interests attach to the new property.[84]  We should distinguish between the consequences of an incorrect name registration as between the secured party and a subsequent secured party taking a security interest in the after-acquired property specifically, and as between the secured party and a debtor.  Suppose SP1 takes a security interest in all the present and after-acquired property of D.  D then acquires new property but registers its ownership under an incorrect name.  The system does not discover the prior security interest registered by the correct name, and so the prior interest is not specifically attached to that property.  It is nonetheless straightforward to provide that the security interest in that after-acquired asset is enforceable against the debtor, since the point of perfection is to protect third parties.  To deal with the problem of a competition with a third party, an ownership registration under any name other than the correct name would be invalid, so that a subsequent transferee from the same transferor who registered under their correct name would have priority.  This provides D with a strong incentive to register under the correct name in order to protect its ownership interest.  Further, one of the main advantages of avoiding the application of the after-acquired property clause is that D would then be in a position to grant a security interest in an unencumbered asset.  But a subsequent secured party (SP2) taking an interest in the property would have a strong incentive to ensure that the property was registered under the correct debtor name, since otherwise SP2 would be exposed to subsequent interest holders who did register by the correct name.  The debtor who had registered by an incorrect name would be entitled to amend the registration, but on doing so SP1's prior interest would be revealed.

[84]This should not be a serious problem on initial registration as the debtor wants to disclose all its property in order to provide collateral.

The next problem is how to deal with security interests registered against names which are inexact matches to the name of the transferee. One approach would be to automatically register all such inexact matches against the newly acquired specific asset and rely on the procedures allowing the debtor to discharge financing statements which are erroneously registered. This approach has the disadvantage of burdening 'innocent' transferees who have the misfortune of having a name similar to that of a debtor with a security interest in after-acquired property registered against them. An alternative approach would be to use more stringent match criteria for automatic attachment to after-acquired property than is used in searches generally. This puts a higher onus on secured parties to use the correct name when registering their security interest. This is not unreasonable. In a sense it is a *quid pro quo* for the ability to automatically capture after-acquired property. And it is better to but the burden on the secured party, who benefits from the transaction, than on the innocent transferee with a name similar to that of the debtor. Note that inexact matches under the PPSAs burden the secured party dealing with the debtor, who must verify whether the inexact matches are the same person as their debtor. They do not burden the innocent parties whose similar names resulted in the inexact match.

The above solutions to the problem of inexact matches highlight a disadvantage of our proposed system, namely that it requires registration by both name and asset description. In comparison, an advantage of traditional land titles systems which are parcel indexed is that a secured party can be entirely secure in its registration if it registers by the correct asset description alone, and there is no need to prescribe a strict form for debtor name. But registration by debtor name is not unknown in parcel indexed land systems. New Brunswick applies the same debtor name rule under its *Land Titles Act* as it does under the PPSA out of a concern for improving the ability of subsequent judgment creditors to discover and register against the assets of a debtor.[85] Anecdotal evidence indicates that, as would be predicted, this has indeed imposed noticeable additional inconvenience and costs in mortgage lending. At the same time, the New Brunswick experience shows that it is not infeasible to apply naming conventions in the context of asset based

[85] *Land Titles Act* R.S.N.B. 1973 c.L-1.1, Naming Conventions Regulation 2000-39.

registration. Note that the rule requiring a transferee to register by its correct name is not as onerous as the same rule in respect of a secured party, since the transferee doesn't need proof from itself of its own correct name.

The system could be implemented either an archival system or a title guarantee system, though it would be more certain under a title guarantee system. The system operates by matching the debtor name against which the security interest is registered, with the name of the owner of any newly registered property. In an archival system the most recently registered transferee is owner is not definitively the owner, since ownership depends on the efficacy of the instrument itself, which is not assessed on registration. An invalid transfer in the chain of title will invalidate the security interest. As a practical matter this should be a relatively minor problem.

A further constraint is that the system must be electronic in order to implement the automatic perfection feature efficiently. In principle functionally the same method could be implemented manually. A rule could be implemented that whenever a party seeks to have title to an asset registered in their name, they must present a recent search of their name in the debtor index. If the search discloses a security interest in collateral including after-acquired property, the registry staff will then register the interest against the specific asset. The manual method has obvious disadvantages. It would be more costly because of the extra paperwork and searching required on the part of both the registrant and the registry staff. These costs would be incurred in respect of each registration, even when there was in fact no prior security interest with an after-acquired property clause to be disclosed. Nor could it provide the same level of security as an automated system, since there would necessarily be some window depending on how a "recent" search result would be defined. In contrast, if designed in from the outset, this approach should add relatively little cost to a computerized registry system. It would probably not be worthwhile to implement this approach in a paper based system.

#### 6.3.5 **Copyright and Asset Based Searching**

Asset based searching is not feasible for copyrights. Asset based searching requires a unique identifier for each property such as a motor vehicle serial number or a geographical parcel identifier in the case of land. This criterion is clearly satisfied for patents and trade-marks which are assigned unique identifiers on registration. Copyrights, however, are probably incapable of being sufficiently reliably identified to form the basis for asset based searching. Asset indexing under the current copyright registration system is by title. But the title is probably not an adequate identifier for the purposes of asset based searching.[86] First, unlike a motor vehicle serial number or a patent number, the title of a copyrighted work is not unique. Different works with the same or similar titles are common. Titles are more like debtor names in this respect. Defining the registration and search requirements for debtor name has proven to be a source of considerable difficultly in the operation of the PPSA. But the fact that debtor name searches are workable does not imply that copyright title searches would also be workable. Some ambiguity in debtor name is acceptable because a party dealing directly with the debtor can take steps to determine whether close matches or proximate name turned up in a search do refer to the debtor. In contrast, reliance on the asset description is most important when dealing with the collateral in the hands of someone other than the debtor who granted the security interest. With nothing more than a title, the secured party cannot verify that the song "Loving You" which has a security interest registered against it is different from the song of the same title which their debtor wants to use as collateral.[87] This is why an asset description, unlike a debtor name description, must be truly unique if it is to be used for asset based searching.

An even more significant hurdle is that while debtors do have legal names which can be well defined (even though it may be inconvenient to verify that legal name), there is no single legal

[86]"The copyright registration system is based on the title of the registered work. In a situation where the author grants a security interest in a work whose title has changed, it becomes impossible to verify the ownership of rights in this work, any prior licences or assignments therein or even other security interests previously granted. One can easily imagine the schemes to which an unscrupulous debtor might resort in order to hide from a creditor the registration of another security interest in the same work." Spring- Zimmerman et al. at 23.

[87]Of course the secured party can always ask for a warranty from its debtor that the debtor was the first author, or other assurances that the work in question is different from the encumbered work. But if the secured party is willing to rely on warranties from the debtor then there is no need for a registration system.

title of a copyrighted work. The title of a work for the purposes of registration is whatever the copyright owner says it is. How can a searcher know whether the book “Revolt in the Desert” which is unencumbered is different from the book “The Seven Pillars of Wisdom” which has a security interest registered against it?[88] The current provincial systems for serial numbered goods are premised on the notion that the serial number is in fact a reliable unique identifier, and the dispute is largely as to when the burden of registration by serial number should be imposed. In contrast, if asset based searching were implemented for copyright, it would be necessary to provide special rules to determine priorities when the security interest was not discovered because the title of the work it was registered against was not the title which the third party used to search, recognizing that neither title can be considered the true title.

It might be suggested that the CIPO could assign a unique number to each federally registered copyrighted work, but in order to ensure that the same work was not registered twice under different titles and so assigned different numbers, the copyright office staff would have to examine the works themselves and compare them to already registered works. The administrative burden and consequent cost makes this impractical. Thus, though asset based searching could be mandated for copyright, it would be so unreliable as to be scarcely be worthwhile.

### 6.3.6 **Search and Registration Burden**

One advantage sometimes claimed for a provincial approach is that it would allow a creditor to take a security interests in all the debtor’s personal property with a single registration. But just as federal/provincial systems coordination integration can be used to reduce the search burden in a provincial system, so it can be used to reduce the registration burden in a federal system. We have seen that the federal system should use notice financing and should be automatically cross-indexed so that it would be possible to register a security interest in IPRs by debtor name rather

[88] “Revolt in the Desert” is the title given by D.H. Lawrence to his abridgment of “The Seven Pillars of Wisdom”.

than by specific asset. If this is done, then a “gateway” approach to registration of security interests can be adopted in which a centralized request to register a security interest in all of the debtor’s personal property would automatically register the interest federally against the IPR as well as provincially against the traditional personal property. This functionality could either be provided through the provincial personal property security systems or through a commercial service provider. Admittedly this approach would not provide a truly transparent “one-stop” registration, since if provincial debtor name rules were not uniform the registration, in at least some jurisdiction (where federal and provincial name rules differed) would have to provide two different debtor names in different registration fields. In this sense the underlying dual registration would be seen by the user and the system would not be truly seamless. Nonetheless, the necessary dual registration could be made very convenient.

Conversely, a federal system would require dual searching in any case in which the creditor wished to take a security interest in all the debtor’s property, not just the IPRs. Even so the search burden would be less than in a provincial system. In a federal system the creditor would need to search the provincial system only by the names of its own debtor, rather than by the names of all predecessors in title. Further, the results in a federal system would be more reliable. Because the search on the IPR side would be conducted in a single registry rather than back and forth between the federal ownership and provincial security registries, the uncertainty stemming from inconsistent debtor names would be eliminated. Nor would there be a need to search any foreign system, or accept the risk of undiscoverable foreign interests. At the same time, a gateway approach could also be used to further reduce the search burden in the federal system by providing a one-stop search venue. As with registration, the dual search would not be completely transparent because of the potential need to enter two different debtor names to accommodate federal and provincial name rules.

### 6.3.7 **Title Guarantee System**

As noted above, the fact of a ownership registry marks a fundamental difference between federal

IPRs and other types of personal property. This immediately raises a question which, curiously, seems not to have been raised in previous commentary. This question is whether the federal system should be reformed to implement a title guarantee system analogous to a land titles (or Torrens) system for land.

Existing federal registration systems are, at most, archival systems. That is to say, they operate in the same fashion as a traditional instrument registry system in the land context: unregistered documents are void as against registered documents, but registration does not itself determine ownership. It is necessary to review the chain of title to ensure that the person currently shown as owner is in fact the owner. The alternative to an archival system is a title guarantee system analogous to a land titles system for land, whereby the registered owner is statutorily deemed to be the true owner. Such a system could, if desired, be implemented in respect of uniquely identifiable types of intellectual property such as patents and registered trade-marks.

In the land context a title guarantee (land titles) system is widely considered to be superior to a instrument registry system as it provides increased certainty and reduces duplication of effort in searching title. On its face, a title guarantee system would be desirable for IPRs for the same reason that it is desirable in the land context, namely the elimination of duplicative searching. Admittedly, there are differences between IPRs and land which make the analogy imperfect. The term of most IPRs is limited and IPRs become less valuable near the end of their term and so are increasingly less likely to be transferred. For both these reasons searching a chain of title to an IPR may be less onerous than searching a chain of title to land.[89] But the question is not whether a title guarantee system for IPRs is as desirable as such a system for land, but whether it is more efficient than an archival system for IPRs. The disadvantage of a title guarantee system is the additional burden it shifts onto the registry office. The advantage is that title documents are reviewed only once, rather than each time there is a transfer. This suggests that so long as IPRs are, on average, transferred more than once,[90] a title guarantee system is preferable to an archival

[89] And of course a title guarantee system in the IPR context could only guarantee who the IPR belongs to: it would not be a guarantee that the IPR was valid.

system.

If a title guarantee system is desirable, this almost necessitates a federal approach to security interests in IPRs. This is because under a provincial system the full chain of title must be available to allow parties dealing with an IPR to search for the name of prior debtors in order to search the provincial security interest registry for security interests given by predecessors in title. In a title guarantee system prior owners are hidden behind the registry "curtain."

A title guarantee system probably could not be implemented in respect of copyrights, primarily because of the difficulty of uniquely identifying the copyrighted work. A title guarantee system requires that the registry staff examine the documents of transfer and verify the true ownership once and for all at the time of registration of a transfer. The degree of certainty required means that the registry staff would not be able to rely on the title alone. Examination and comparison of the work itself with previous works would be required and this would present a prohibitively costly administrative burden. Further, where the first owner of the copyright is the author, ownership reverts to the heirs of the author 25 years after the death of the author notwithstanding an previous assignment.[91] Since this is a generally unknown group it would not be possible for a title register to automatically show the heirs as the owner.

### 6.4 Scope

#### 6.4.1 Security in Provincial IPRs

As we have seen, the major problems with the provincial approach stem from federal authority over the ownership and the transfer of ownership of federal IPRs in combination with the existence of federal ownership registries for all six categories of federal IPRs. Because there is

[90] This is not to say that each individual IPR must be transferred more than once for a title guarantee system to be desirable. It is sufficient if some IPRs are transferred more than once.

[91] *Copyright Act* s.14.

no ownership registry, either provincial or federal, for provincial IPRs, there is no apparent advantage in including these types of collateral within the sweep of a substantive federal secured transactions regime even assuming this were constitutionally permissible. Rather they should continue to be governed, as they are now under the provincial choice of law rules, by the law of the jurisdiction where the debtor is located. This would include the protection accorded to unregistered trade-marks under s.7(b) of the *Trade-marks Act*. Though the protection is accorded by federal law, no ownership registry is required.

### 6.4.2 **Security in Unregistered Copyrights**

We have seen that the principal advantage of the federal substantive solution is that it permits coordination of the law governing security with the rules governing registration of ownership in the federal IPRs. The difficult case is copyright, the one form of federal IPR that is not dependent on federal registration for its existence. A particular problem arises in respect of works under development, software being a prime example. Under the provincial approach a security interest in such a work can be readily obtained with a single registration under the debtor name. This is often regarded as a significant advantage of the provincial approach.

Under a federal approach, one option to unregistered copyright is to provide that the general secured transactions law of the debtor's location would govern. Unfortunately, this does not solve the problem of works under development. In order to maintain the integrity and reliability of the federal record, any secured party taking an interest in an unregistered right would have to be subordinated in the event that the debtor subsequently registered the copyright federally and then granted a competing federal security interest in (or assigned) the registered copyright. Thus a secured creditor would be unable to secure its priority ranking by registration federally in cases where registration of the copyright itself would be premature at the time security is taken or where the product is under continuous evolution. The secured creditor could protect itself by requiring the debtor to register the copyright federally before a security interest is taken, but this would face practical problems when the work is under development. The other option is to provide that federal registration would be required to perfect a security interest in all copyrights, even where the copyright itself has not yet been registered at the time security is granted. The objection to this approach which is usually raised is that it appears to be even worse than the first alternative with respect to work under development, in particular software. Under the first alternative continually updated federal registration is required to avoid the possibility of subordination; in this second alternative continual registration is required to achieve any protection at all.

The problem here is not unique to copyright. Rather, it is the problem of after-acquired property. We have discussed above an approach to the federal registry which would accommodate security interests in after-acquired property. If this approach to registry design is adopted federal registration is no longer an impediment to publicizing interests in unregistered copyright. The first approach outlined above should be adopted. Provincial law would govern copyright in unregistered works, so that a secured creditor who had registered provincially would be fully protected, unless the work were subsequently registered. To protect itself against a subsequent registration followed by a grant of a security interest/assignment, the secured creditor could, if it wished, register a security interest federally against the debtor's name. If the unregistered work were then registered, it would automatically attract the security interest.

### 6.4.3 **Security in Royalties and Debtor/Licensor's Contract Rights**

A debtor/licensor's right to collect royalty payments from its licensees can be used as security or assigned outright in the same way as any other chose in action or claim. Should a security interest in royalty payments owing to a debtor/licensor be governed by federal law, as being a form of a security interest in an IPR, or by the law of the debtor's location, as being a form of account? A lender taking a security interest in the IPR will normally wish to take a security interest in the royalty stream at the same time. This suggests that a security interest in royalties in the same manner as the underlying IPR to avoid the need for dual registration. But dual registration itself should not be a serious burden, if a gateway approach to registration is adopted, or when the lender is taking a security interest in all of the debtor assets. And provincial registration of security interests in royalties does not raise the same search problems as we saw in the provincial approach to security interests in IPRs generally. The royalty payments in question will normally be based on licences granted by the immediate debtor. Long chains of assignments of the royalty payments themselves will not be common. For example, if the debtor is an exclusive licensee with the power to grant end-user licences in a particular geographic area, the lender will need a chain of title search to ensure the debtors exclusive licence is not subject to prior encumbrances, but the lender is concerned only with the royalty payments derived from the sub-licences, not payments owing to the original owner of the IPR who granted the exclusive licence to the debtor. For this reason the relevant security interests in royalties would be readily discoverable even if registered only the debtor's jurisdiction, and not in the federal registry. Thus federal registration of security interests in royalty payments is not essential in a federal system.

The advantage of allowing such security interests to be governed by the law of the debtor's location is that all accounts, whether based on IPRs or otherwise, would be governed by the same law. This avoid characterization issues which might otherwise arise. (For example, would accounts due for technical support services provided by the licensor in respect of the licenced software be considered as royalty payments or as a separate account? Would it matter if the service agreement were in the original licence or in a separate contract?)

On the whole we recommend that security interests in the licensor's rights under a licence, including the right to royalty payments and any non-monetary rights, should be treated as a separate form of collateral governed by the general secured transactions law of each province or territory of residence of the debtor.

#### 6.4.4 **Security in Licensees Interest in a Licence**

Exclusive licences which must be registered in the federal ownership registry in order to be binding against subsequent parties are tantamount to assignments. Security interests in such exclusive licences, like security interests in an ownership interest, would be governed by federal law under the federal approach.

In contrast, security interests in non-exclusive licences, which do not have to be registered in the federal registry in order to be effective against subsequent parties, should be perfected under provincial law (or, more precisely, the law of the debtor's location). Since the non-exclusive licence itself cannot be discovered by a federal search, leaving the security interests in the non-exclusive licence to the provincial system does not impair the integrity of the federal register any further. Provincial registration is also more convenient, particularly in cases where the licence in question is an end-user licence needed to run the business and the debtor does not have other significant IP assets, so that lender might have no other reason to register federally.

Note that this does not imply that a security interest registered provincially will necessarily be enforceable against the licensor. This issue is discussed below.[92]

### 6.5 Summary and Recommendations

The federal approach which we recommend would be a mixed variant in which federally registered interests would have priority over any provincially registered interest, but provincial registration would remain effective except in a competition against a federally registered interest holder or anyone claiming under them.

The reformed federal system would legally reliable, up to date, on-line searching. It would adopt a notice registration system for security interests similar to that used in the provincial systems. Security interests in after-acquired property should be implemented using a system which automatically cross-indexes debtor name with owner name and asset description. This would allow automatic specific appropriation of after-acquired property. The federal ownership and security interest registries, if separate, should have uniform debtor name rules and should be accessible through one-stop "gateway" searching and registration. The gateway should similarly

[92] **

link the federal and provincial security registries.

A title guarantee system should be considered for uniquely identifiable IPRs, in particular patents.

The federal system would apply only to federal IPRs and security interests therein. Provincial IPRs and security interests in them would be wholly governed by the law of the debtor's location.

Security interests in royalties and other rights of a licensor in respect of federal IPRs should be governed by provincial law, not by the federal system.

## 7 Licences

### 7.1 Introduction

Licences are a very important means of exploiting IPRs. This Part deals with a number of issues relating to licences and security interests therein which are relevant to both a provincial and federal approach.

### 7.2 Ordinary course licencing transactions

#### 7.2.1 Introduction

The existing provincial personal property security regimes provide that a transferee of an interest will take clear of a prior security interest in certain defined circumstances, the most important of which is when the subsequent interest is acquired in the ordinary course of business. Both the Revised Article 9[93] and the proposed changes to the Model PPSA[94] extend this rule to licensees.

[93] §9-321.

As Adams and Takach argue, the arguments in favour of this priority rule are compelling, at least for ordinary course licensees of mass-market software.[95] We recommend that this rule be adopted in either a provincial or federal system.

Where exactly the line should be drawn is a matter of more controversy. As with the ordinary course rule in existing provincial personal property security regimes, and as with the definition of exclusive licences, experience will be needed to flesh out the precise contours of the rule.

### 7.2.2 **Nature of the Rule**

The precise nature of the ordinary course rule needs to be resolved. In PPSA jurisdictions the ordinary course purchaser only takes clear of security interests granted by the seller, whereas in Quebec the ordinary course purchaser takes clear of all security interests, including those granted by predecessors in title to the seller. In a provincial system the applicable provincial rule would apply to intellectual property as it would to other property. In a federal system a decision would have to be made as to whether the PPSA rule or the Quebec rule would be adopted. The two rules differ in their results when the debtor transfers to a purchaser/retailer not in the ordinary course and the retailer then transfers to an ordinary course purchaser. The disadvantage of the PPSA rule is that imposes a risk of an undiscoverable security interest by the remote debtor on the ordinary course buyer. The disadvantage of the Quebec rule is that reduces the SP's security. The secured party is not entirely unprotected, as it would have a continuing security interest in the proceeds (though of course these might be dissipated) and it has some possibility of monitoring its debtor to detect the bulk sale. Monitoring may well be difficult, but that difficulty should be contrasted with the position of the ordinary course purchaser of ordinary goods, who has no possibility of detecting the security interest. In the IPR context it would be possible in principle for the ordinary course purchaser to discover the prior interest by an asset description search, but it is exactly this type of search which the ordinary course rule is designed to preclude. On the

[94] Cuming & Walsh proposed s.30(2.1)

[95] See the discussion in Adams & Takach.

whole, we recommend the adoption of the Quebec rule, but this is a weak recommendation, as we do not see conclusive arguments on either side.

### 7.2.3 **Scope of the Rule**

Should the rule that ordinary course licences take clear of prior interests apply to exclusive licences or assignments as well as to non-exclusive licences? In existing personal property security regimes the ordinary course rule currently applies to outright assignments and a straightforward analogy would apply the rule to assignments and exclusive licences of IPRs. But the existence of an ownership registry for IPRs is important. In this respect IPRs are like land, for which an ordinary course subordination rule has never been applied or even suggested.

In their extensive discussion Adams & Takach suggest that the ordinary course be limited to "results of production" as distinct from the "tools of the trade" as best reflecting the expectations of all parties. In particular they suggest that "where the debtor owns copyrights or patents, any disposal of ownership rights by the debtor. . .cannot be assumed to be in the debtor's ordinary course of business."[96] This might be appropriate in the case of non-exclusive licences, but we feel it does not adequately address problems raised by exclusive licences and assignments.[97]

We would go further and recommend that the ordinary course rule not apply to any interest which requires registration in order to maintain priorities against subsequent transferees. This is not simply a matter of a presumption against finding an ordinary course transaction involving registrable interests; rather it is a prohibition on applying the rule to such interests, so that a subsequent assignee or exclusive licensee would never take clear of a prior registered security interest without a subordination agreement. This is necessary to maintain the integrity of the title registry. If we permit exclusive licences granted in the ordinary course take clear of a prior

[96] Adams and Takach at 17.

[97] Adams and Takach are not entirely clear as to whether they intend their recommendation to apply to exclusive licences and assignees. They refer throughout their paper to the need to protect "transferees", but their specific examples deal with non-exclusive licences.

interest holder then the state of title cannot be determined from the face of the register: in order to determine state of title a purchaser from secured creditor on realization needs to know whether licence was granted in the ordinary course. This might be considered acceptable with respect to the initial purchaser, who has some means of discovering the context of the licence, but a subsequent purchaser from that initial purchaser would face the same problem. As a corollary, a title guarantee system could not be implemented, since the registrar could not adjudicate on whether every exclusive licence was granted in the ordinary course.

Further, it is unlikely that an exclusive licence would be granted in the ordinary course. The justification for subordinating the prior secured party is implied consent, and keeping in mind that exclusive licences are those which have a significant impact on the value of the IPR (so that we consider them matters of importance to potential subsequent interest holders), it is unlikely that a prior secured party would consent to that type of licence in the ordinary course. It is possible that it might happen on occasion; but in that case an express subordination agreement could be obtained. In that way the integrity of the title register would be maintained, and since such transactions would tend to be high value, the added transactions costs should be acceptable. For these reasons we recommend that the ordinary course rule should not apply to exclusive licences. This accords with the position in the Revised Article 9.[98]

This suggests that it might be convenient to if exclusive licences and ordinary course licences were defined in a complementary fashion, so that any licence which did not have to be registered to bind subsequent grantees would also take free of subsequent interests. But convenience is not sufficient. While non-exclusive licences might often be granted in the ordinary course, so there is no doubt considerable practical overlap between the two concepts, the definitions are conceptually different, with the concept of exclusive licence looking to the reasonable expectations of subsequent grantees, and the ordinary course licences looking to the expectations of the licensee and secured party. Nor would any practical problem arise with respect to licences which are neither exclusive nor in the ordinary course of business. Such licences would not have to be registered to bind subsequent purchasers, but they would nonetheless be subordinate to

[98] §9-321(b).

subsequent transferees. An assignee of the non-exclusive licence would not be able to tell from the face of the record whether its interest was clear of the prior security interest, but if the interest was valuable enough to worry about, an acknowledgment of the assignment could be sought from the secured party.

### 7.3 Security interest in licensee's interest in licence

#### 7.3.1 Validity

The first issue is that of the validity of security a licensee's interest in a licence. The Ontario Court of Appeal case of *National Trust v. Bouckhuyt*[99] challenged the validity of security interests in licences. The case has been universally criticized as wrongly decided. Proposed revisions to the Model PPSA would make is clear that security interests may be granted in licences. Though *Bouckhuyt* concerned a regulatory licence and IPR licences might well be distinguishable the case has nonetheless cast doubt on the validity of security interests in IP licences. In either a federal or provincial system reforms similar to those proposed for the Model PPSA should it be implemented to make it clear that a security interest in a licensee's interest in a licences is valid.

#### 7.3.2 Anti-Assignment

The validity of a security interest in a licence is a different issue from the enforceability of an anti-assignment clauses in the same licence. Note that in view of the public policy concerns regarding the control of the identity of licensees by licencing bodies, the proposed revisions to the Model PPSA would not impair the ability of the licensor to control the transfer of the licence: see s.9(5): "A provision in any other statute which restricts or requires the consent of the grantor to the transfer of a licence or the creation of a security interest in a licence is ineffective but only to the extent that the provision would prevent attachment of a security interest in the license under this Act." The effect is that the secured party may take a security interest in the licence, which

[99] (1987), 7 P.P.S.A.C. 273 (Ont. C.A.).

would extend to the proceeds on foreclosure, but the licence cannot be sold at foreclosure without the approval of the licencing body. The secured party may take a security interest in the licence, but the value of the that licence as collateral is subject to the grantor's assignment policy. A similar question arises in respect of licences of IPRs.[100] Should a provision in the licence agreement prohibiting transfer of the licence by the licensee be effective? Note that the proposed s.9(5) of the Model PPSA does not address this issue as it refers to "a provision in any other statute" which restricts a transfer of the licence or requires the consent of the grantor to the transfer of a licence. This clearly not cover contractual restrictions on transfer. We take this wording of s.9(5) to reflect the focus on statutorily regulated licences, such a milk production quotas or broadcast licences, which have generated the most controversy regarding security interests in licences, and not to reflect a positive decision by the drafters that contractual restrictions on the transfers of licences should be ineffective. Indeed, the existing s.9(5) is entirely silent on the issue of contractual restrictions on assignment.

Our view is that licensors of IPRs have legitimate interests in controlling the identity of licensees. For example, if a software developer granted an exclusive licence for a certain geographical region to a particular marketer, it would not want to see the licence acquired by its major competitor on foreclosure by the marketer's SP on default. For this reason we recommend that it be made clear that the policy of the Model PPSA in respect of regulatory licences be applied to all licences. That is, contractual restrictions on assignment of the licence should be ineffective but only to the extent that they would prevent attachment of a security interest. The licensor could rely on restrictions to refuse to recognize the rights of a non-approved purchaser on foreclosure. This policy is also reflected in the Revised Article 9.[101]

[100] "As it is common for licence agreements to preclude any assignment by the licensee of its rights without the express consent of the licensor, it may be necessary for the secured creditor to obtain an acknowledgment and consent from the licensor to any subsequent assignment of the license agreement upon the debtor's default and the secured creditor's realization under the security agreement." Spring-Zimmerman et al at 7.

[101] See commentary to RA9 9-408; and see the discussion in Weise. Note that §9-406 provides for that anti-assignment clauses in accounts are entirely ineffective, while §9-408 provides that anti-assignment clauses in general intangibles (which do not include accounts) are ineffective only to the extent that they impair the creation attachment or perfection of a security interest, but they are effective if they prevent enforcement. The licensor's right to payment is an account, and so falls under §9-406, while the licensees right to performance is a general intangible and so falls under §9-408: see §9-408 Official Comment Example 2.

### 7.4 Security interest in licensor's interest in a licence

#### 7.4.1 Anti-Assignment

A related issue is the status of anti-assignment clauses in the licence agreement. Anti-assignment clauses in an agreement between an account debtor and an assignor are ineffective against third parties under the PPSA (**Quebec?). The right of a licensor of IPRs to assign its right to royalties raises a similar policy question. The analysis is slightly different as a licensor may have ongoing obligations under the licence agreement (e.g. software support obligations) and some concern has been raised that the licensor will have less incentive to fulfill those obligations once the right to payments is assigned. But these arguments are not persuasive. The licensor may wish to assign its right to royalties precisely in order to raise money to carry out its obligations. And it is in the assignee's interest as well to ensure that the obligations are carried out, since breach of the obligations will normally entitle the licensee to stop or reduce its payments, and this will normally be effective against the assignee. We therefore recommend that provisions prohibiting a licensor from assigning its right to royalty payments be ineffective against third parties, as is the case with other types of accounts under the PPSA. This is also the result under Revised Article 9.[102]

#### 7.4.2 True licence v financing licence

The dividing line between assignment and the grant of security in intangible assets is not always an easy one to draw even if one uses a substance of the transaction test. This characterization challenge is one reason why the drafters of the PPSAs and the CCQ decided to apply roughly the same publicity, priority and enforcement rules to both the assignment and hypothecation of

[102] "Thus, section 9-406 permits the creation and enforcement of a security interest in a right to payment arising out of a general intangible, including a license of software, even if the contract or other law restricts the licensor's right to assign its right to payment. . . .The concern here is that if a licensor can assign its right to receive money, the licensor may lose its incentive to perform its future obligations under the license, to the detriment of the licensee." Weise at 1089.

security in intangible claims. A similar issue arises in respect of IPR licences. When is a licence a security interest? A licence has some *prima facie* similarities to a security interest: a licensee often owes an obligation to make ongoing payments to the licensor, like a debtor does to a secured party; and the licensee's interest can be 'repossessed' by the licensor for failure to make those payments.[103]

The issue is more important under the provincial approach, where registration in the wrong venue could render the interest ineffective against third parties. Presumably this would normally be overcome in practice by dual registration in cases of doubt. The issue is much less significant under the federal approach. True exclusive licences and financing licences might have different formal registration requirements – a financing statement versus full document registration – but so long as the interest was registered in one form of the other, subsequent parties would be put on notice. The distinction might be significant at the enforcement level. If there was a distinction in the formal registration requirements then a true assignment which was incorrectly registered as a security interest should not be ineffective against third parties.[104] Rather, a less drastic solution of a requirement of registration in the proper form should be implemented. In either case, the diminished significance of this distinction is a point in favour of the federal approach.

## 7.5 **Summary and Conclusions**

We recommend that non-exclusive licences granted in the ordinary course of business should not be subject to any prior registered security interest.

Anti-assignment clauses in a licence agreement prohibiting a licensee from assigning its interest should be recognized as being effective. A clause prohibiting a licensor from assigning its

[103]The issue was discussed in the drafting of the Revised Article 9: see Weise.

[104]Note that it is not obvious that there would be any significant difference in the form of registration, since exclusive licences might be registered by means of a notice rather than by full document registration. The form of registration of licences is beyond the scope of this Report.

interest should be ineffective.

## 8 Enforcement

Under the provincial and territorial secured transactions regimes, the standard default remedy is sale of the collateral. In order to exercise this remedy, there needs to be some mechanism to enable the buyer at the secured creditor's liquidation sale to be recorded as the new owner in the relevant federal IP registry. At present, secured creditors typically require the borrower to exercise an assignment in registrable form at the time of the initial borrowing that can be used if and when default occurs. Alternatively, the borrower is required to execute a power of attorney in favour of the secured creditor to do whatever is necessary on default to effectuate a sale of the collateral including the execution of an assignment and its submission for registration. The latter is the recommended course, particularly with trade-marks, to avoid any challenge that the mark has lost its distinctiveness in the absence of control by the assignee/secured creditor.[105] In any event, these awkward and burdensome procedures of uncertain effectiveness could be eliminated if the law were to provide an express procedure whereby on presentation of a transfer document executed by the secured creditor n the prescribed form, the Registry were required to record the purchaser as the new owner. Although a procedure of this kind has been recommended for inclusion in the PPSAs[106] to be fully effectual reform at the federal level is required and we so recommend.

## 9 Conclusions

Secured lending based on IPRs faces challenges both because of valuation difficulties and because of the inadequate legal regime governing security interests in IPRs. We conclude that

[105] See Spring-Zimmerman et al.

[106] See Cuming & Walsh.

formal governmental action directed at improving the valuation expertise of financiers of IP collateral is not required. Valuation expertise has been and will continue to be developed by the private sector as the importance of IP assets increases.

In contrast action is needed to modernize the legal regime governing security interests in IPRs. The present system is radically uncertain in essentially every respect. Modernizing the IPRs security will improve access to and lower the cost of secured credit based on IPRs. It will also indirectly improve valuation; lowering this barrier to the use of IPRs will help set up a "virtuous circle" in which improved demand for IPR based security and will increase lenders familiarity with IPR based collateral and thus improve valuation techniques.

We have described two main approaches to security in IPRs. We will not review the details of these approaches here: our summaries and recommendations from the body of the text are repeated below for convenience. At this point we wish to emphasize the basic factors affecting the choice between the two systems.

The first approach which we reviewed was the misnamed provincial approach, in which the law relating to security interests in IPRs is that of the location of the debtor. The fundamental disadvantage of this approach is the problems which arise from the need to search title through a ownership registries and security registries in different jurisdictions. If the debtor names rules are not uniform among all the jurisdictions, including the ownership registries and the security registries, a full search chain could be very burdensome. In some cases it would not be possible to conduct a reliable search, as the ownership registry would not provide sufficient information about the correct name of a predecessor in title to allow a reliable search of the security registry. This problem would be significantly ameliorated by uniform debtor names rules among the provincial and federal registries. However, even this would not solve the problem of foreign debtors. If a foreign debtor appeared in the chain of title it would be necessary to search a foreign registry, if one existed, for encumbrances; and in some cases foreign law would not require registration of security interests in IPRs, in which case the prior interest would be undiscoverable.

There is no solution to this problem in a provincial approach short of a world-wide IPR security registry, and this, needless to say, is not on the horizon. Note that a gateway approach to searching in which would direct a single query to multiple registries would not address these problems. Certainly a gateway search approach is desirable, but it is not a solution to the fundamental problems. It is really no more than a basic pre-requisite to a provincial approach.

The second approach is the federal approach. One of the most common objections to a federal system is that it would require dual registration to take a security interest in all of the debtor's assets. We do not consider this to be a strong point. On the contrary, in view of the search problems raised in a provincial system, it is reasonably clear that the overall search *and* registration burden under a federal system is much less than under a provincial system. And problem of dual registration in particular can be largely overcome with a one-stop gateway registration system, similar to the gateway search system proposed for the provincial system.

Another common objection is that a federal approach would require a more radical overhaul of the federal registry system. While this point has some merit, we do not feel it to be a strong objection. The current federal system requires a major overhaul even to allow the proper operation of a provincial system. In comparing the provincial and federal approaches the question is what *additional* reforms which would be required to implement the federal approach. These should be technically minimal.

The most serious problem in the federal system is conceptual: the implementation of a system to allow security interests in after-acquired property in the context of an asset indexed system. The ability to take security interests in after-acquired property without subsequent specific appropriation is a major advantage of the current provincial systems. It would count as a significant objection to a federal system if we could not implement a similar feature in that context. We have proposed a system which would allow security interests in after-acquired property in a federal system. The question is whether this or an alternative system would be effective in this regard.

The following questions, then, need to be addressed in comparing the approaches. With regard to the provincial approach: In practice how serious a burden would chain of title searching for prior encumbrances be in the absence of uniform debtor name rules? In practice how serious a burden would chain of title searching for prior encumbrances be with uniform debtor name rules? What is the likelihood of implementing uniform debtor name rules? In practice how serious a burden is foreign debtor problem? And with regard to the federal approach: Can an effective system for implementing security interests in after-acquired property can be implemented.

On the whole we recommend the federal approach. We believe that the problems facing the federal approach can be overcome with good system design. The provincial approach faces an irreducible problem of due to the possibility of foreign debtors in the chain of title, and this problem is likely to get worse in an increasingly global economy. We should note, however, that our recommendation is based on a comparison of the best forms of the federal and provincial systems. In particular, if the basic reform of the federal ownership registry which we consider essential to the effective operation of either a provincial or federal system are not implemented, both the provincial and federal approaches would suffer, but they probably would not suffer equally. The comparison of the two systems would be different in such a “second-best” world. It is not possible in this Report to compare the various approaches under all possible scenarios, but we hope that this Report will provide a framework for so doing.

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# 11 Review of Summaries and Recommendations

## 11.1 Valuation Challenges

Formal governmental action directed at improving the valuation expertise of financiers of IP collateral is not required.

The inherent legal nature and characteristics of intellectual property pose valuation risks for secured creditors of a different nature and extent that arise in relation to other types of property. With the exception of the points noted in the recommendations listed below, this valuation risk cannot be reduced by changing the legal incidents and attributes of intellectual property without compromising fundamental policies of intellectual property law to an unacceptable extent.

The policy justification for the rule whereby, if the first owner of the copyright is the author, ownership reverts to the author's heirs 25 years after the author's death notwithstanding any previous assignment, should be revisited to determine whether it is justified despite its negative impact on the predictability of the future value of copyright collateral.

The non-assignability of authorial moral rights reduces the value of copyrights and renders valuation more unpredictable. Although moral rights may be waived, the scope of the beneficiaries entitled to take advantage of a waiver is unclear under the current Copyright Act. The relevant provisions should be amended to confirm that subsequent assignees and secured creditors are entitled to invoke the benefit of a waiver executed in favour of a prior assignee in the absence of a contrary intention. Consideration might also be given to amending the Act to provide, that in the case of registered copyrights, registration of the author's intention to retain moral rights is a pre-condition to the effectiveness of those rights against subsequent assignees and secured creditors.

## 11.2 Uncertainty in Existing Law and Practice

In our view, legislative authority over all aspects relating to ownership and the third party effects of the assignment and transfer of federal IPRs should be exercised exclusively at the federal level. The supplementary application of otherwise applicable provincial law principles creates uncertainty both because of the lack of conscious coordination between the federal and provincial rules and because of the difficulty of predicting which provincial (or other) laws may intersect with the federal rules.

However, if federal law is to provide certain, reliable and predictable guidance, the substantive provisions relating to the third party effects of registration in the federal IP registries need to be expanded to provide a fully comprehensive regime. In our view, this would best be accomplished by reforming the federal intellectual property statutes to provide:

> (1) that federal registration of an assignment or transfer of any federal IPR is an absolute pre-requisite to its third party effectiveness even if the federal IPR is not itself registered as will often be the case for copyrights;
>
> (2) that successive assignments or transfers of the same IPR by the same assignor are ranked on a strict first-to-register basis.
>
> (3) that all exclusive licences should be subject to the federal ownership registration regime.

Reform of the federal substantive rules governing the registration and priority status of assignments and transfers of federal IPRs will produce little real benefit unless the federal IPR registries are significantly reformed to permit cheap and efficient remote access. Because structural reform of this kind is relevant to additional issues of substantive reform to be discussed imminently, we will defer making detailed recommendations until later in the Report.

## 11.3 **The Provincial Approach**

To this point we have seen that the existence of a federal ownership registry makes the major forms of federal IPRs different from traditional personal property and more akin, in some ways, to land. The existence of an ownership registry complicates the search burden for prospective secured creditors and assignees as compared to traditional personal property, because of the need to search up the chain of title to ensure a clean chain of title including protection against the risk of a grant of security by a predecessor in title to the immediate debtor.

Under a provincial approach, this chain of title search is also more complex than for land because the ownership registry and the security interest registries are separate, because the chain of title search may require multiple searches to be conducted in multiple jurisdiction, and because no security registry may exist where the debtor or predecessor in title is from a foreign country.

The need to search for antecedent security interests granted by predecessors in the debtor's chain of title to the immediate debtor adds to the search burden in respect of IPRs used as collateral under a provincial strategy The practical extent of this additional burden is not clear. It depends on the extent to which the IPRs used as collateral originated, by assignment or licence, with someone other than the debtor. This is likely to depend on the particular industry.

A common gateway approach to searching the provincial security registries and the federal IP registries would substantially reduce this search burden. However, the remaining search burden would be significant. If complete uniformity in debtor name rules among provinces and between the provincial and federal registries is lacking a fully reliable chain of title search may not be possible. Achieving this uniformity may be a significant barrier to implementation.

Further, the common gateway solution would not assist to secured creditors and assignees in verifying the risk of security having been granted by an owner in the chain of title who is located outside of Canada. The additional inquiry burden and risk this imposes would vary according to whether the secured transactions regime in force in that particular jurisdiction operated an encumbrance registry of the kind in place in the Canadian provinces and territories.

Asset-based indexing of IPRs would do away with the need for interprovincial and federal uniformity at the debtor name level, but would depend on uniformity of adoption by the various provinces and territories, which is by no means guaranteed. Moreover, this approach would have a negative impact on the ability of debtors to grant security in generic categories of IPRs through a single agreement and a single filing. For these reasons asset-based indexing of IPRs at the provincial level is not recommended.

### 11.4 **The Federal Approach**

The federal approach which we recommend would be a mixed variant in which federally registered interests would have priority over any provincially registered interest, but provincial registration would remain effective except in a competition against a federally registered interest holder or anyone claiming under them.

The reformed federal system would legally reliable, up to date, on-line searching. It would adopt a notice registration system for security interests similar to that used in the provincial systems. Security interests in after-acquired property should be implemented using a system which automatically cross-indexes debtor name with owner name and asset description. This would allow automatic specific appropriation of after-acquired property. The federal ownership and security interest registries, if separate, should have uniform debtor name rules and should be accessible through one-stop "gateway" searching and registration. The gateway should similarly link the federal and provincial security registries.

A title guarantee system should be considered for uniquely identifiable IPRs, in particular patents.

The federal system would apply only to federal IPRs and security interests therein. Provincial

IPRs and security interests in them would be wholly governed by the law of the debtor's location.

Security interests in royalties and other rights of a licensor in respect of federal IPRs should be governed by provincial law, not by the federal system.

## 11.5 **Licences**

We recommend that non-exclusive licences granted in the ordinary course of business should not be subject to any prior registered security interest.

Anti-assignment clauses in a licence agreement prohibiting a licensee from assigning its interest should be recognized as being effective.  A clause prohibiting a licensor from assigning its interest should be ineffective.