CIVIL SECTION

LAW COMMISSION OF CANADA

LEVERAGING KNOWLEDGE ASSETS – MINIMIZING UNCERTAINTY FOR SECURITY INTERESTS IN INTELLECTUAL PROPERTY

(DRAFT REPORT)

(CONFIDENTIAL)

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Summary

Part 1: Introduction

[1] Secured credit is an efficient form of lending, which, when implemented in a proper legal and institutional framework, can reduce transaction costs associated with borrowing and thus stimulate economic activity. Historically, secured lending laws and institutions associated with specific types of property have been reformed as that type of property assumed increased economic importance. Land was one of the first types of property used as collateral, but as the economy changed from an agrarian to manufacturing economy the focus shifted from land to moveable assets such as equipment and inventory, and from tangible assets to intangible assets such as accounts receivable. As intellectual property increases in importance it is not surprising that increased pressure has arisen to improve the framework for secured lending based on intellectual property rights ("IPRs"). It is not only technology sector enterprises that would benefit from this reform. Any modern enterprise, from manufacturing to the service sector, holds significant IP assets in the various forms from business software to licence rights. This Report discussed legal and institutional reforms that are needed to facilitate IPR-based secured lending.

[2] For the purposes of this Report a distinction is to be drawn between "federal" IPRs, which fall within federal legislative jurisdiction, and provincial IPRs, which fall within provincial authority. The most important federal IPRs, which are the focus of this Report, are patents, copyrights, registered trade-marks. Reform is most urgent in respect of federal IPRs because it is the presence of federal title registries for the federal IPRs which present the most significant obstacles to IPR-based secured financing. Provincial IPRs can be accommodated within the existing provincial secured lending systems with relatively minor reforms.

[3] The main challenges to secured lending based on IPRs are valuation difficulties and deficiencies in the legal and institutional secured lending framework.

Part 2: Inherent Valuation Challenges

[4] The inherent legal nature and characteristics of IPRs pose unique valuation risks for secured creditors compared to other types of movable and immovable property. To being with, most IPRs have a statutorily limited legal life. More importantly, since IPRs are by nature concerned with innovation, all IPRs have a potentially limited economic life, as any particular IPR is susceptible to being rendered obsolete by further innovation. In addition, IPRs are often most valuable in a specific application in a specific company and in consequence the liquidation value may be significantly lower than the use value. IPRs are also subject to being challenged for validity whenever they are enforced, which introduces a discount as well as uncertainty into the valuation process.

[5] Despite these characteristics, many IPRs are potentially valuable as collateral, either individually or when pledged en masse, but these inherent valuation challenges do introduce uncertainty as compared with other types of property. In general, this valuation risk cannot be reduced by changing the legal incidents and attributes of IPRs without compromising fundamental policies of intellectual property law to an unacceptable

The greatest potential for reduction in valuation risks associated with IPRs is probably the improvement in valuation techniques that will occur with experience. Reducing other barriers to the use of IPRs as collateral is likely to have an indirect effect on reducing valuation risk; as the use of IPRs increased and experience is gained, valuation will become more reliable.

Part 3: Uncertainties in the Current Federal Registration and Priority Framework

[6] The existing law relating to security interests in IPRs is radically uncertain. There is uncertainty at almost every level. Before security interests themselves are considered, the first step that any secured creditor, or more broadly, any potential assignee, must take is to ascertain the debtor's title to collateral. Though title registers exist at the federal level for all federal IPRs, these are not ideal for purposes of title investigation. Under three of the Acts – the *Trade-marks Act*, the *Industrial Design Act* and the *Integrated Circuit Topography Act* – registration of an assignment in the federal title is merely permissive, so that examination of the title register does not provide authoritative information regarding title. Under the remain three Acts – the *Patent Act*, the *Copyright Act*, and the *Plant Breeders' Rights Act* – an unregistered assignment is void against a subsequent assignee without notice who registers first. Even so, details of existing law mean that the register is not entirely authoritative. In particular, the first-registered assignee must take without actual knowledge of the prior unregistered assignment. This qualification creates residual uncertainty and has been eliminated in modern registry design in other contexts. Further, it has been held judicially that priority established by registration is subject to exceptions to first-in-time priority created by otherwise applicable principles of provincial property law, thus further undermining the integrity of the register as a source of title information.

[7] When security interests are brought into consideration, the uncertainty increases dramatically. There is fundamental uncertainty with respect to virtually all aspects of priority. In the first place, it is not clear whether secured transactions even fall within the scope of the federal registration provisions. It is possible that all secured transactions are federally registrable; or that only those which are formally cast as assignments are registrable; or that none at all are registrable. Even if registration of a security interest does not establish priority of its own effect, it may be that annotation of such a registration may serve as notice or constructive notice, and so establish priority indirectly (though this is not clear).

[8] In addition to this profound legal uncertainty, current registry practices are not sensitive to the informational needs of either prospective secured creditors or prospective assignees of federal IPRs. The patent, copyright and trade-marks databases are currently accessible on-line, but the on-line source were designed for other purposes, e.g. searching prior patents, and are not adequate for due diligence searching in respect of either financing or purchasing as they may be incomplete or out of date.

[9] This uncertainty increases direct costs as lenders are routinely advised to register under both federal IPR law and provincial secured transactions law and to observe the formal requirements of both systems. But this practice does not eliminate priority uncertainty, and the profound uncertainties surrounding the priority effects of federal registration, and the interaction and potential conflict of the federal statutes with provincial secured transactions law, mean that secured creditors enjoy far less confidence in the quality of IPR collateral relative to other movable assets. This imposes an increased initial risk assessment and ongoing monitoring burden on secured creditors for which debtors ultimately pay in the form of less accessible and costlier secured credit.

[10] Although the benefits of a reformed legal framework for IPR-based secured financing are difficult to quantify, the current uncertainties are sufficiently well documented and pervasive to conclude that reform will reap sufficient cost savings to justify the investment. The case for reform is especially pressing in view of the likelihood of an increased demand for IPR-based secured financing, and the likelihood that reform by itself will in turn fuel that demand by increasing access and lowering cost.

Part 4: Reform of the Ownership Disclosure Function of the Federal IPR Registries

[11] Reform of the title aspects of federal IPR registries is an essential pre-requisite to any approach to reform of security interests in IPRs. Title level reform will facilitate the efficiency of all types of commercial transactions in

federal IPRs, including secured transactions, by providing commercial parties with a cheap, efficient and reliable source of information as to the current ownership of IPRs. However, the statutes as presently drafted not only fail to achieve this potential, they actually introduce a further layer of confusion.

[12] To resolve this deficiency in the title aspects of the federal IPRs registers, we recommend that the assignment and registration provisions of all six federal IPR statutes be strengthened to provide for the registrability of all transfers of ownership in federal IPRs, and to give conclusive legal effect to registered transfers as against unregistered transfers. In particular, we recommend that: successive assignments or transfers of the same IPR by the same assignor should be ranked on a strict first-to-register basis and that the scope of registrable transfers should include exclusive licences. Complementary structural and operational reform of the registries themselves to allow reliable on-line title searching is needed to support these substantive reforms.

Part 5: Choice of Law Approach

[13] The reforms recommended in Part 4 would improve the ability of prospective secured creditors to investigate a prospective debtor's legal title to the collateral, thus reducing one important source of the legal uncertainties identified in Part 3. But further reforms are needed to address the uncertainties in the priority of claims to the same federal IPR between competing secured creditors and between a secured creditor and a federally registered assignee. Part 5 addresses a "choice of law" approach to this second problem, while Parts 6 and 7 discussed a "federal" approach.

[14] Under the choice of law approach, the federal government would defer to the law of the debtor's location as the law applicable to the registration, effects of registration or non-registration, and priority of security granted in any federal IPR. For Quebec debtors the relevant provisions of the CCQ would apply; for debtors located in the other provinces and territories, reference would be made to the

relevant PPSA. For non-Canadian debtors, foreign secured transactions law would govern, e.g. French law for French debtors.

[15] If this approach is adopted, we recommend that it be implemented by a federal choice of law rule specifying the law of the debtor's location as the applicable law. The alternative would be to remain silent on this point and allow the choice of law rules of the litigation forum to specify the applicable law. For litigation in Canada, this would also result in the application of the law of the debtor's location, but there is sufficient provincial variations at the level of detail that this approach would result in uncertainty and potential conflict in the applicable law. For similar reasons we recommend that federal law also specify a priority rule ranking assignees and secured creditors according to the respective times of registration of their interests in the relevant federal IP registry and in the secured transactions registry of the province or territory where the debtor is located.

[16] The disadvantages of the choice of law approach stem from the fact that it severs the law applicable to the registration and priority status of security rights in federal IPRs from that applicable to their ownership and assignment; the law of the debtor's location would apply on the security side, federal law would apply on the ownership and assignment side.

[17] This has two main disadvantages. First is the chain of title problem. In order to ascertain priority a prospective secured creditor must search the chain of title to the IPR federally and then search all the various registries corresponding to the location of the prior owners disclosed by that title search in order to determine whether those prior owners had granted prior security interests had been granted. Thus the existence of the federal title register makes searching significantly more complicated that in respect of traditional personal property. Further, lack of uniformity in debtor/owner name rules between provincial and federal registries means that valid security interests granted by prior owners may remain entirely undiscoverable, even after a full search. The only way to eliminate this source of uncertainty would be to implement uniformity in provincial debtor name rules.

This in itself would be a major law reform undertaking. "Gateway" searching in which a single on-line portal would automatically query multiple registries, could relieve some of the technical burden of searching multiple jurisdictions, but it would not eliminate the need for multiple searches, nor could it eliminate the problems arising from lack of uniform debtor names.

[18] The second main disadvantage of the choice of law approach is the foreign debtor problem. Under the choice of law approach security interests in Canadian IPRs granted by foreign owner/debtors would be valid encumbrances if adequately publicized according to the law of the debtor's location. This means that verifying encumbrances affecting an IPR could necessitate searching a foreign registry (and gateway searching would obviously not be possible). Worse, many countries outside of North America do not operate general encumbrance registries of the kind established by the provincial and territorial secured transactions regimes in Canada and by Article 9 in the United States. Thus valid prior security interests might be entirely undiscoverable.

Part 6: Federal Substantive Approach

[19] The alternative to the choice of law approach is a federal approach under which the federal IPR statutes would be amended to explicitly provide for the federal registration of security rights in federal IPRs. Priorities between a secured creditor and an assignee, or between competing secured creditors would then be governed by the order of federal registration. That is, security interests as well as outright assignments would be registrable federally, and once so registered would have priority over any competing assignment or security which was not so registered.

[20] While we refer to this as a federal approach, the reach of federal law would be limited in the version which we recommend. First, it would apply only to federal IPRs. Provincial IPRs would be treated as general intangibles under

existing provincial secured transactions law. Further, only security interests in federal IPRs themselves would be subject to the federal regime. Security interests in IPR related rights, in particular security interests in rights to royalty payments, would be excluded. And even with respect to security interests in federal IPRs themselves, the registration and priority rules of the secured transactions law in effect in the debtor's home province or country would be preempted only for the purposes of resolving a contest involving at least one federally registered claimant. A security interest in a federal IPR which was only registered provincially, though subordinated to any federally registered interest, would nonetheless be effective to establish priority against any interest which was not registered federally, and as against the debtor's insolvency administrator.

Part 7: Structural and Operational Reforms of the Federal IPR Registries to Accommodate the Federal Approach

[21] Some legal and structural reforms to the federal registry system are necessary or potentially desirable to accommodate the federal registration of security interests. For the most part the necessary reforms should be undertaken in any event to modernize the title aspects of the federal IPR registries. These legal and design issues were discussed in Part 4. Reforms specific to security interests are discussed in Part 7. The most basic specific reform to the federal registries needed to implement the federal approach to security interests in IPRs is simply to make specific provision for the federal registration of security interests. This should be technically very minor if carried out in conjunction to the title-side reforms discussed in Part 4.

[22] There are two ways in which a registration might be implemented. In a document registration system the actual security documentation would be filed, whereas in a notice registration system only a notice setting out only the basic factual particulars needed to alert third parties to the potential existence of a security interest. Experience at the provincial registry level has proven that the notice registration system is far superior to the document registration system, and

we strongly recommend that it be adopted for federal registration of security interest. Incidentally, it would also be technically easier to implement than document registration.

[23] It is sometimes suggested that because the federal registries are indexed and searched according to each specific item of IPR, adoption of a federal priority regime would impede creditors who hold security in the whole of a debtor's present and after-acquired movable assets from effectively perfecting their security in the debtor's after-acquired federal IPRs so as to ensure priority over competing claimants. We believe this concern is ill-founded. In fact, it is easier to deal with after-acquired property under the federal approach than under the choice of law approach. The most basic solution would be to create a separate federal name-indexed registry for security interests and similar encumbrances. A searcher would first search the federal ownership registry to determine the chain of title to the relevant IPR and then search the federal encumbrance registries for encumbrances granted or registered against all owners in the chain. This would be simpler than under the choice of law approach because only two registries would be searched, instead of multiple registries, and the problem of non-uniform names is avoided.

Part 9: Conclusion

[24] Secured lending based on IPRs faces challenges both because of valuation difficulties and because of the inadequate legal regime governing security interests in IPRs.

[25] Action is needed to modernize the legal regime governing security interests in IPRs. The present framework is radically uncertain in essentially every respect. Modernizing and rationalizing the rules governing security in IPRs 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 increased demand for IPR based security will increase lender familiarity with IPR collateral and thus indirectly improve valuation techniques.

[26] Of the two basic approaches to the problem, we recommend the federal approach. The choice of law 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. Under the federal approach, it would be necessary to search only two registries: the federal title registry and the federal security interest registry. Debtor name variation and the accompanying uncertainty would be eliminated. The foreign debtor problem would also disappear as foreign creditors, like any other creditor, would be required to register federally in order to establish their priority.

SUMMARY OF RECOMMENDATIONS

THE REDUCTION OF LEGAL UNCERTAINTY

Recommendation 1

Parliament should reform the framework governing federal intellectual property rights in order to reduce the legal uncertainty associated with taking such rights as collateral.

ENHANCING THE EXISTING REGISTRY SYSTEMS

Recommendation 2

All of the federal intellectual property statutes should create true title registries so that registration of a transfer of a federal intellectual property right will be conclusive evidence of legal title as against any unregistered transfer.

Recommendation 3

The federal intellectual property registries should be governed by a strict first-to-register rule of priority in which knowledge of a prior unregistered interest is irrelevant.

Recommendation 4

The federal intellectual property registration regimes should apply to exclusive licences.

Recommendation 5

The federal intellectual property registration systems should be overhauled to ensure that they support reliable, current, on-line searching of the full chain of title of all intellectual property rights.

THE CHOICE OF LAW APPROACH

Recommendation 6

In order to resolve the priority claims of secured creditors to federal intellectual property rights, Parliament could enact a federal choice of law rule that designates the law of the debtor's location as the law applicable to registration and priority. Because this approach makes it more difficult to search a chain of title and creates problems where foreign debtors are involved, it should be regarded as a second best solution and should be adopted only if Parliament thinks that it is unable to implement a federal substantive approach to the problem.

THE FEDERAL SUBSTANTIVE APPROACH

Recommendation 7

Parliament should amend the intellectual property statutes to provide for the federal registration of security interests in the intellectual property registries.

Recommendation 8

The federal registry system for security interests in intellectual property should apply only to federal intellectual property rights. Security interests in royalty payments should be excluded from the scope of the federal system.

Recommendation 9

Registration of a security interest in the federal intellectual property registry systems would be required in order to give it priority over other interests that are subsequently registered in the federal system. Registration of a security interest in a federal intellectual property right in the provincial registry system would be effective to establish priority over any interest that was not registered federally, including the debtor's insolvency administrator.

Recommendation 10

The federal registry system for security interests in intellectual property should adopt a notice registration system.

Recommendation 11

The federal registry system for security interests in intellectual property should provide a separate federal name-indexed registry for security interests and should permit a secured creditor to register in respect of after-acquired intellectual property rights.