Independent Film & Television Alliance®

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10 August 2009

Mr. Peter Hallahan
Committee Secretary
Standing Committee on Legal and Constitutional Committee
Department of the Senate
PO Box 6100
Parliament House
Canberra ACT 2600, Australia

Re: Inquiry into the Personal Property Securities Bill 2009 - Tabled Text Version

Gentlemen:

The Independent Film and Television Alliance ("IFTA") greatly appreciates the opportunity to again provide its views to aid the Senate Standing Committee on Legal and Constitutional Affairs in evaluating the draft Personal Property Securities Bill 2009 ("PPSB"). We hope our views will assist the Committee in preparing a version of the PPSB that will benefit all Australians.

As mentioned in our prior submissions, we believe there are many areas where the PPSB improves existing financing laws in Australia. Many of these improvements will work well for intellectual property. However, in some cases there remain mismatches between the PPSB and intellectual property law. The purpose seems to be to allow licensees to more easily finance licensed intellectual property even at the expense of intellectual property owners. This policy can adversely impact financing of new intellectual property, especially motion picture production, where we are most concerned. We believe the legislature can resolve many of these mismatches by clarification of the PPSB. To this end we offer the following observations.

1. Overview:

In our previous submissions, we addressed specific language in the PPSB and its application to intellectual property. Rather than repeat those observations, we would like here to focus more on policy choices the legislature might wish to consider in adopting the PPSB.

a. Current System

As we understand it, Australia, like many other countries, initially developed an array of specific financing devices for specific types of personal property, often operating at the state or territorial level. While this may work in discrete cases, it makes things difficult for borrowers seeking "enterprise" financing that encumbers all their available assets with a single financing device, especially for a nation-wide operation. The PPSB therefore proposes to reform Australia's current system of personal property financing by adopting at the Commonwealth level what is often described as a "unified, functional" approach. This approach takes the view that "property is property" and so proposes a unified system with common operational rules for personal property security transactions. Of course, these rules are not suited to all types of

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assets, so real property and an array of intangibles are excluded. (PPSB § 8). However, the PPSB seeks to apply its system to as many types of personal property as possible.

As previously mentioned, IFTA is a trade association for independent motion picture producers and distributors in multiple countries, including Australia. Our members include producers (borrowers) and financial institutions (lenders) with extensive experience in international financing. Our focus is on a specific type of financing, *i.e.,* motion picture production, which involves copyrights, trademarks and, recently, patents.

Current law works well for our members. Motion picture financing, indeed nearly all intellectual property financing, is a "specialty" system, to be sure. Basically, one uses a "mortgage" on the intellectual property rights in the motion picture to be produced. The mortgage gains priority by filing in the company register (copyright) or patent or trademark office. The basic goal of intellectual property law is to encourage new creations. The mortgage financing system is well-suited to that goal. It focuses on the specific intellectual property asset and allows the financier by a single filing to encumber the asset and gain priority over later transferees and related royalty streams. In essence, motion picture production financing is analogous to real property financing, say an office building. There is a "dirt mortgage" on the property (like the mortgage on the copyright); it has priority over later space leases in the building (like licenses) which may have their own financing (like a charge on a licensee).

Thus, the issue is how this current practice would operate under the unified, functional system proposed by the PPSB given the different policy goals of each body of law.

b. Policy Goals of the Unified, Functional Financing System

The unified, functional model allows financing an array of assets as they may exist from time to time in an enterprise. It does so by replacing former asset-specific devices with a single "security interest." This security interest is optimized for use as a "floating lien" (U.S. terminology) or "enterprise" or "all asset" lien. The model still allows other types of financing, of course. A pledge still works. A purchase money security interest operates something like an asset-specific chattel mortgage. However, these are accommodated by special attachment and priority rules, not but by a whole new financing regime. The model furthers two policy goals.

First, it more easily allows enterprises to raise operating capital by encumbering as much of their assets as possible. The unified, functional system is thus well suited to the needs of operating companies financing a diverse and changeable asset base. The underlying property rules for *tangible* assets, which suppress "hidden" title restrictions in favor of "ordinary course purchasers," work hand in hand with the rules in the unified, functional system.

Second, the model also facilitates another type of financing: "securitization." In technical terms, a grantor assigns all its receivables to a new "Special Purpose Vehicle" ("SPV"). The SPV issues securities based on the receivables, pays the grantor a discounted price, and profits on the float. The theory is a grantor can "borrow" money more cheaply from the capital markets than from a traditional lender. Securitization transactions can involve vast numbers of individual receivables. Checking each contract individually would increase due diligence costs. Thus, the unified, functional system adopts legal rules that suppress contractual terms in individual receivables that could prevent their assignment to an SPV or use as security. Some unified, functional systems were developed in the 1990s when securitization was the darling of the financing world. (The U.S. reform was adopted in 2001.) The current financial crisis has perhaps given a different perspective on the utility of securitization.

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c. Contrasting Policy Goals for Intellectual Property

When considering how unified, functional financing systems apply to intellectual property, the central issue is: "Who gets the money?" An intellectual property owner (generally "licensor") often grants rights for a royalty based on exploitation income earned by the licensee, *e.g.*, 50% of "net profits" from sublicensing. Assume a licensee receives, say, $100 of sublicensing income. Can the licensee assign all its income to its lender as collateral, so that in case of default the lender gets the entire $100? Or its $50 net share? Put another way, can the licensee use the *licensor's royalty share* as collateral for *its* loan, or only *its* own share?

A comparable situation happens for goods. A seller may wish to use a contractual term, say "retention of title," to recover the goods or at least their resale income in case of non-payment. But this requires a buyer's enterprise lender to examine numerous individual purchase orders to uncover these rights. The unified, functional model seeks to resolve these individual collateral disputes globally within the framework of the secured financing law. It does so by converting retention of title contractual claims into security interests. The means the unpaid seller can only recover goods or receivables ahead of the buyer's enterprise lender through the priority rules in the secured financing law, typically a "purchase money" security interest. As a commercial matter, this result conforms to usual expectations for tangible goods, as the property rules already give preference to "ordinary course" transfers over "hidden title restrictions."

The PPSB now proposes to apply this approach to intellectual property licenses. That is, contractual license terms that may limit a licensee's ability to use licensed rights, or the licensor's royalty share, as collateral, will be altered or suppressed in favor of resolving issues through rules in the secured financing law. Now, on the one hand, the PPSB takes a very positive approach in according an intellectual property licensor a "purchaser money" security right so that there is a mechanism within the secured financing law for the licensor to gain priority as to its claim to royalties. However, the PPSB also alters other contractual terms that derive from rights accorded in intellectual law, which can lead to conflicts if not clarified.

In intellectual property practice, a licensee's rights are routinely subject to restrictions in prior transfers in the "chain of title." Thus, as a commercial matter, parties are accustomed to adjusting their respective rights through private contracts, and intellectual property law supports this practice by giving a licensor the ability to stop uses, even by remote users, that violate contractual authorizations. As a trade association, IFTA has long prepared sample contracts for international motion picture licensing. In these contracts the licensor's claim to royalties either as a general creditor or preferred creditor is routinely negotiated. In some cases the licensor requires security for payment, *e.g.*, letters of credit, lock-boxes and security agreements. In other cases, the licensee insists the licensor is a general creditor subordinate to the licensee's loan facility. The result in each case depends on bargaining power.

To be sure, the legal result without bargaining is not uniform. A few judicial decisions have treated a licensee as a fiduciary with respect to payment of royalties. Other decisions say a secured creditor must pay royalties on the theory it can only take "what the licensee has. Other decisions have treated the licensor as merely a general creditor for royalties.

As a result, parties allocate their position using contract provisions grounded in the rights accorded under intellectual property law. Three contractual provisions are typically used. One is the right to terminate, especially for non-payment. Another is an "anti-assignment" clause that limits assignments and sublicenses, including the licensor's royalty share. Finally, there are

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priority rules in the intellectual property statutes. As discussed further below, the PPSB now alters these contractual rights.

d. Basic Policy Choices

In addressing the impact of the PPSB on intellectual property financing, the legislature faces a basic policy choice. Does its desire more to facilitate financing by producers and creators to develop new intellectual property, or by licensees and end users to use licensed intellectual property and the licensor's royalties for their own benefit? The answer will condition the response to many of the specific provisions of the PPSB discussed below. As a trade association for motion picture producers, it goes without saying IFTA supports the former goal.

A particular choice can have consequences. The motion picture business employs a range of creative talent, such as writers, directors, actors, and producers, who routinely rely on royalties, or "residuals." If they are unable to collect payment, they often appear on the legislature's doorstep for relief. This has happened in the United States, where there is special "cut-through" legislation for distributors to pay residuals, and in the European Union, where there are non-waivable rights to "equitable remuneration" for various uses. These rights often supersede contrary provisions in secured financing law. We favor a system that respects party autonomy and the results of free bargaining rather than these statutory approaches since we believe they do not adequately reward success and usually result in expensive collective management. However, to the extent a secured financing law suppresses the ability collect "up-stream" payments, these are potential consequences. Similarly, producers who cannot ensure collection of income from licensees may well require "relief" through subsidies and tax breaks.

In our view, the current system of individual contractual bargaining over whether a licensee can use its licensed rights and exploitation income as collateral for loans represents the most efficient utilization of resources for *intellectual property* commerce. Just as the PPSB recognizes specialty rules for certain situations, such as pledges or deposit accounts, it should recognize specialty rules for intellectual property. To these specifics we now turn.

2. Financing Example:

In order to examine how specific rules in the PPSB fit into a financing transaction, we propose to examine the policy choices in the PPSB by considering the following example.

> **Example**: Australian Producer desires to produce a motion picture. Producer proposes to grant Australian Lender a security interest in the "motion picture collateral" to obtain a loan for production. The "motion picture collateral" will consist of: (i) copyright in existing screenplay (and licenses to use any underlying work such as novel); (ii) rights in underlying talent and related services agreements; (iii) copyright in movie when completed ("future asset"); (iv) copyright in any "ancillary rights" such as music soundtrack, images of characters used for toys and merchandise, etc.; (v) trademark in title and any merchandising rights (e.g., "character" names like "Terminator"); (vi) possible patent rights in any new software/special effects; (vii) related physical items, e.g. film negatives, prints, DVDs, etc.; and (viii) royalty receivables from licensing rights to theatrical, video and television distributors and broadcasters.

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Under current Australian law, the Lender would take a "mortgage" or "fixed charge" in all of these assets. If the Producer is a registered company (most likely), evidence of the financing would be filed in the company's register. As trademarks and patents (if any) came into existence, they would be duly registered, and evidence of the mortgage would be recorded in the applicable trademark and patent registers. This procedure should give the Lender priority over later bona fide transferees and any insolvency administrator of the Producer. *See* Melvin Simensky, Lanning Bryer & Neil J. Wilkof, *Intellectual Property in the Global Marketplace*, Chp. 31 Australia (2nd ed. 1999) describing current practice.

How will this loan transaction work under the PPSB?

3. Creation of the Security Interest:

As mentioned, under current practice, the Lender would typically use a mortgage or fixed charge over all the motion picture collateral, including the copyright in the existing screenplay and in the other assets when produced (e.g., "future copyright") as well as license royalties.

a. Creation Mechanics

The PPSB would generally fit well with current practice in regards to creating the security interest. Under PPSB § 18, the Lender would use a "security agreement" as the financing device rather than a mortgage. The security agreement can cover existing and after-acquired property. Under PPSB § 20(6), the security agreement could extend to royalties as "proceeds" even if not specifically identified as such. No "magic words" are needed, so existing motion picture loan documents should easily qualify as security agreements with few if any changes.

b. Partial Assignments – Termination Rights

One issue the Lender must face is the impact of the PPSB on the ability of a Producer to terminate a transfer, especially for non-payment. As mentioned in our previous submissions, PPSB § 12(5)(a) says a "security agreement" does not include *a license*. However, under the Copyright Act, transfers can be by exclusive license or *partial assignment*. Some transferees, especially SMEs, desire "assignment" language to access certain subsidies or tax incentives.

PPSB § 12(2) defines a "security interest" as an "assignment" given to "secure payment or performance of an obligation." Would a partial *assignment* with a termination right now become a "security interest" under the PPSB? If so, the Producer could not contractually terminate a partial assignment for non-payment but must instead go through the foreclosure and redemption process. This shifts the commercial context in favor of the assignee and its lender, who get a second chance to "redeem" the rights through the secured financing law.

We raise this point because there has been some debate in academic literature, at least in the United States, whether unified, functional security laws turn partial assignments (or even exclusive licenses) into "security interests" on the theory that royalties are a "delayed purchase price." This is part of the approach of trying to resolve collateral challenges through the secured financing law rather than by contractual provisions which must be individually uncovered.

This issue was debated when drafting the UNCITRAL Legislative Guide on Secured Transactions. The Guide clarifies that its use of "assignment" refers only to "receivables."

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UNCITRAL Guide ¶ 88. The current draft of the UNCITRAL IP Annex is comparable. WP.39 ¶ 26 (IP "license" with right to terminate is not a security right) and ¶ 32 (IP Annex uses "transfers" to distinguish that "assignments" apply to receivables).

As far as we know, this is still an academic debate. We are unaware of any litigation on the point, so this may not (yet) be much of a risk. However, many unified, functional financing laws were enacted when expanding the reach of financing laws was the vogue. These laws have not yet been "stress tested" in bankruptcy cases. That may happen soon.

The policy choice for the legislature is whether the issue warrants clarifying the intent of the PPSB. The legislature may have confidence the Australian judiciary will reach the right result. (But which one is intended?) Otherwise, clarification would be helpful.

4. Attachment of the Security Interest:

PPSB § 19 provides that a security interest is only effective against the grantor if it has "attached" to collateral. Attachment requires that the grantor have "rights in the collateral or the power to transfer rights" and that "value is given." In addition, for the security interest to be effective against third parties, it must effectively "describe" the collateral under PPSB § 20.

a. Attachment Mechanics

Whether a grantor has "rights in collateral or the power to transfer rights" will typically depend on the property rules for the collateral. For motion pictures, to meet this requirement a Lender will conduct proper due diligence to obtain assurances that the Producer has obtained necessary rights to produce and exploit the motion picture from applicable talent and right holders. As to giving "value," any consideration sufficient to support a contract will do under PPSB § 11. In the United States, a binding commitment to make a loan, even without actually advancing funds, has been held sufficient for these purposes, and presumably the same would apply under the PPSB. Finally, motion picture loan documents often include expansive descriptions of the collateral, and as such should satisfy PPSB § 20. Thus, the Lender's current motion picture loan documentation should also be sufficient to meet the attachment requirements under the PPSB. However, the PPSB raises some issues the Lender needs to consider.

b. Extension of "Power to Grant" Rights

One issue is the meaning of the "power to transfer rights." Here is an area where the PPSB proposes a significant change in intellectual property law to facilitate secured financing.

PPSB § 79 says "if collateral would be able to be transferred … but for a provision in an agreement … prohibiting the transfer … the collateral may be transferred, despite the provision … by consent between the grantor and the transferee." Under intellectual property law, the usual rule is: assignments and exclusive licenses (as ownership transfers) are transferrable, including by sublicense, unless restricted in the instrument; whereas non-exclusive licenses are not transferrable, or capable of sublicensing, unless authorized in the instrument. PPSB § 79 seems to alter this rule. It would apparently allow an assignee or exclusive licensee to grant further "transfers" even if their agreements restricted so doing. The term "transfer" is not limited to a grant of security interest and may include further assignments and sublicenses. It is unclear what this does to non-exclusive licenses since they usually "would not be able to be transferred."

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PPSB § 79 could impact intellectual property financing. Assume an exclusive license from the author of a novel to the Producer authorized production of a movie but prohibited granting a security right to the Lender. Would PPSB § 79 allow Producer to grant Lender the security right anyway? That is, can the security right attach because PPSB § 79 gives the Producer the "power to grant rights" even if the license agreement prohibited so doing? What if the author's license prohibited any transfer of video rights because the author wanted to reserve them? Would PPSB § 79 allow this transfer?

PPSB § 79(2) allows a secured creditor to declare an unauthorized transfer a default, but not another party. What if the author prohibits the Producer from transferring the video rights because the author had already granted exclusive video right to another? Would PPSB § 79 still allow the Producer to transfer video rights, in effect turning both licenses into non-exclusive transfers? While these later two results may not be intended, there is nothing in the language of PPSB § 79 that would prevent them. If this is the intended result, it impairs the exclusive rights granted to intellectual property owners, including the right to control assignments and licenses, as guaranteed under international conventions.

PPSB § 79 appears directed at two issues. The first is a "negative covenant." Assume a grantor agrees to a "negative covenant" in a security agreement that prevents further transfer of the collateral for security. This first security interest is not perfected. A second lender then takes a security interest without knowledge of the first one. The first lender then claims the second security interest never attached because the "negative covenant" deprived the grantor of the "power" to make a second transfer for security. The result is to circumvent the perfection and priority rules in the financing law. If this is the policy PPSB § 79 is trying to address, surely it can be done with more focused language.

The second issue is broader: securitization. As mentioned, in securitization transactions there are often a large number of individual receivables contracts. Examining each one to determine whether it can be assigned for security would increase due diligence costs. Thus, PPSB § 79 appears to wholesale invalidate private contract terms that would prevent "collateral," in particular receivables, from being transferred to an SPV in a securitization transaction. We view adopting such an approach with caution.

Our members are unrelenting in scouring the planet for new funding sources. Over the years, they have tried "securitization" of license royalties (e.g., TV syndication contracts, insurance-backed deals and "Bowie Bonds"). If securitization were an efficient means of financing motion picture production, they would be using it. The problem is that intellectual property licenses are highly sensitive to adjustment or default, thus requiring constant oversight. Issues include scheduling, delivering materials, infringement claims, *etc.* In many ways licenses are more volatile than home mortgages, which have not done so well in securitization deals of late. For intellectual property, it is often more efficient (and prudential) for an established lender to provide revolving credit to an operating company with "hands-on" management of the license contracts rather than to engage in securitization of the royalty streams.

The policy of invalidating "anti-assignment" provisions also has broader sweep than just intellectual property. Many contracts use "anti-assignment" terms for legitimate purposes. Some include: personal service contracts; franchise agreements, where the franchisee's skill is critical; stock exchanges which limit the transfer of seats to qualified recipients; "legend" securities that restrict transfers; partnership interests; club memberships; tickets that stop scalping; software licenses that limit transfer to specific markets, e.g., "educational only" to

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allow discount pricing ("arbitrage"); and, airline tickets that limit transfer for security. The list is extensive. Does PPSB § 79 propose to invalidate anti-transfer provisions in all of these contracts?

With respect to intellectual property, existing law allows an intellectual property owner the ability to grant, or withhold, authorization for use through contractual assignments and licenses. International agreements, *e.g.*, TRIPS, require recognition of this exclusive right. The broad sweep of PPSB § 79 does not seem commensurate with these requirements.

As such, we suggest at a minimum that intellectual property transfers be excluded from PPSB § 79. Alternatively, we suggest PPSB § 79 be narrowed specifically to the "negative covenant" situation.

c. Copies Subject to Intellectual Property Law

A motion picture Lender must also face the impact of the PPSB on physical items subject to intellectual property rights. In the motion picture business, these include film negatives, video masters and related "printing" material needed to make release prints and consumer copies such as DVDs. The Lender will want the security right in the motion picture collateral to extend to these items as well. Intellectual property law accords the Producer various exclusive rights to control the distribution, publication ("first sale") and rental of such copies. The PPSB, however, may restrict the Lender's ability to access these rights as collateral.

PPSB § 105(2) provides that if a registration perfects a security interest in goods that are "subject to a security right such that exercise of rights in relation to the goods necessarily involves exercise of the intellectual property rights," then it also perfects a security interest in the intellectual property. PPSB § 105(3) says this is subject to contrary intention in the security agreement, but all compulsory licenses work in this manner. That is, if the counter-party decides not to "agree otherwise" the intellectual property owner must accept the compulsory license.

We have discussed this issue before. Rather than parsing the language, we would like to focus on the policy. The situation of intellectual property rights used "in relation to goods" has been around for a long time. It has been extensively addressed in the "exhaustion" doctrine. What, if anything, is PPSB § 105(2) trying to do with this rule? If it is merely restating it, why is PPSB § 105(2) necessary? If it is changing it, how and why? If there is an issue in how exhaustion works it should be address in intellectual property law. As far as we know, there has been no serious confusion as to how the doctrine works in practice, either in the purchase or financing of goods used "in relation to intellectual property." Yet adding PPSB § 105(2) could well induce courts to presume the legislature in fact meant to change in intellectual property law.

The result could affect commercial practices. For example, it used to be that retailers would buy DVDs from a distributor with a right of return in case they did not sell. But the retail video and record business has been decimated by Internet piracy. To help with their limited cash flow, distributors have resorted to "shelf rental." They "rent" space on shelves of the stores, ship DVDs, and authorize the retailer to make the "first sale" to the consumer. This places the secured financing law at odds with the intellectual property law. The secured financing law sees the delivery of possession as a "consignment" and converts the transaction to a "security right." This means that the retailer's secured lender (or other creditors) can take the DVDs ahead of the distributor unless the distributor makes a filing under the secured transactions law. The intellectual property law sees this as a limited transfer where no "first sale" occurs until the consumer sale, meaning that third parties who attempt to sell the DVDs are infringers. This

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conflict has been litigated in the United States. The result so far has been to acknowledge the consignment but to allow that intellectual property law supersedes ("preempts") the secured financing law. Thus, the distributor may recover the DVDs "on the shelf" ahead of other creditors of an insolvent retailer unless terms in the distribution agreement allow for finding an express or implied "first sale" to the retailer.

Of course, in the United States this happens because the secured financing law operates at the state level, and thus is subject to the supremacy of federal intellectual property law. Since the PPSB operates at the Commonwealth level, the result may be different in Australia. The issue for the legislature is how it wishes to accommodate these differing commercial practices. The PPSB § 105(2) appears to give primacy to the secured financing law, even ahead of the distribution and rental rights accorded in intellectual property law. Putting aside the legal issues, the practical consequences PPSB § 105(2) could have on small record stores and retailers who face a deteriorating business climate should give pause.

This issue was debated extensively in crafting the UNCITRAL IP Annex. The delegates and professional representatives all have agreed on the following formulation, which the next draft of the IP Annex will propose as a legislative recommendation. See WP.39.Add.1 ¶ 60:

> **Recommendation 243:**
> The law should provide that, in the case of a tangible asset with respect to which intellectual property is used, unless otherwise specified in the security agreement, a security right in intellectual property does not extend to the tangible assets with respect to which it is used, and a security right in such tangible assets does not extend to the intellectual property. However, nothing in this recommendation limits the remedies that a secured creditor with a security right in such intellectual property has with respect to the tangible assets to the extent permitted by law relating to intellectual property, nor does it limit the enforcement remedies that a secured creditor with a security right in the tangible assets has with respect to the tangible assets to the extent permitted by law relating to intellectual property.

We believe this represents a well-reasoned statement of the principal which has garnered wide international support. We would commend it to the legislature for consideration.

5. Perfection of the Security Interest:

Under the PPSB § 55 *et seq.*, a security interest must be "perfected" to gain priority over competing interests. The policy is that a debtor should give notice of the financing to protect later parties who extend credit based on apparently unencumbered collateral. For tangible personal property, the historic means of giving notice was to take "possession," either outright or "constructively" by recording notice. This concept was eventually extended to discrete intangibles, notably receivables, by requiring the creditor to give notice or take some control.

Intellectual property law took its own approach. For patents and trademarks, the legislature established recording systems which provide that an assignment, which should include a mortgage ("collateral assignment with right of redemption"), is ineffective against a later bona fide purchaser unless timely recorded in the appropriate filing office. For copyrights, assignments and mortgages are perfected and take priority on a "first in time" basis, subject to

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recording in the company register if applicable. Thus, under intellectual property law, security rights are perfected by giving third parties *knowledge*, actual or constructive. Under PPSB § 21, for intangible intellectual property, perfection now requires a registration in the PPSB's register. Registration is a *sine qua non* regardless of knowledge. This represents a policy change.

a. Initial Filing Mechanics

How will a Lender perfect its security interest in the motion picture collateral under the PPSB? Under PPSB § 21, the Lender must register a financing statement in conformity with PPSB §§ 149 *et. seq.* However, PPSB §§ 148 & 153(4)(b) allow the Register to issue regulations requiring certain collateral to be described by "serial number," and failure to include a required serial number could mean the registration is unable to achieve perfection.

Serial number registration would be difficult for copyrights since there is no system that issues a copyright "serial number." Copyrighted works are usually described by title, but titles of motion pictures often change. Thus, the description of the "motion picture collateral" commonly used in current loan documents should be what is required in a PPSB registration, as least for copyright interests. As for trademarks and patents, there are registration systems. It seems likely the PPSB Register will require using the IP identifiers as the "serial number."

The UNCITRAL Legislative Guide takes a different approach for assets subject to a "specialized register," like trademarks and patents in Australia. Recommendation 38(a) says for such assets, it should also be possible to make a security right effective against third parties (i.e., to "perfect") by filing in the specialized intellectual property register. The IP Annex agrees. WP.39.Add-2 ¶ 6. As discussed below, we recommend that the *priority* of a security right in a trademark or patent be determined under the Trademark Act and Patent Act. As a result, security rights should be capable of perfection by filing in the trademark and patent office as applicable.

If the legislature follows this recommendation, then it would be necessary to add a technical amendment to PPSB § 21(2) which provides that, for (intellectual property) collateral with its own specialized filing system (e.g., trademarks or patents), an effective filing can (must) be made by filing in the specialized filing system.

b. Additional Filings against Transferees

An issue for the Lender will be maintaining the effectiveness of its security interest against transferees of the motion picture from the Producer. PPSB § 34 says if collateral "is transferred," a perfected security interest only remains perfected until the earlier of: (i) 24 months after the transfer; (ii) the end of any registration; or, (iii) (in case of a competing security interest) five business days after consent to the transfer or notice of the competing security interest. How does this apply to intellectual property?

PPSB § 43(1) says "a *buyer or lessee* of personal property, for new value, takes the personal property free of an unperfected security interest." Initially, it seems this does not apply to intellectual property, which is *licensed,* not "bought" or "leased." If no other priority rules apply, then under PPSB § 20, the Lender's security interest would be effective against (and have priority over) the *licensee* when it attached even, if it later became unperfected. Perfection, however, would be necessary for priority over other secured creditors.

If filing and priority for trademarks and patents occurs by filing in their applicable filing offices, this result would follow under applicable intellectual property laws. For copyrights,

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which will be subject to the PPSB filing rules, a "no new filing against licensees" is a welcome result. The UNCITRAL Legislative allows countries to adopt one of three rules regarding whether filing against a transferee is necessary to maintain perfection under a unified, functional approach. One possibility is that no such filing is required. In the next discussion of the IP Annex there is a proposal to recommend "no new filing" as the rule for intellectual property. See WP. 39-Add.2 ¶¶ 30-36. In our view, this is the commercially reasonable approach, since it makes the security interest law conform to the intellectual property law.

However, PPSB § 105(1) may impose a wrinkle. It says the PPSB applies to intellectual property rights "in relation to goods" in the same way it applies to goods if (i) exercise of the security rights in relation to the goods necessarily involves exercise of the intellectual property rights and (ii) the obligation is also secured by a security interest in the intellectual property rights. (PPSB § 105(3) does *not* allow altering this result in the security agreement.) As we remarked above, conflating intangible intellectual property with tangible goods is inconsistent with intellectual property law. Buying a DVD – tangible property – does not give the purchaser any intellectual property rights in the embodied motion picture.

In nearly every license is it necessary to deliver tangible items to enable the licensee's use of the intellectual property. For example, in a theatrical license, the producer must deliver inter-negatives and related materials to make release prints. In a video license a DVD video master is needed to make consumer DVDs. Use of these printing materials necessarily involves exercise of the intellectual property rights, *e.g.*, reproduction and distribution. As such, the Lender's security interest would extend to these physical items. Yet PPSB § 105(1) seems to say that *if* the Lender wants its security interest to extend to goods as well as the intellectual property, it must let its intellectual property rights be treated the same as the goods. This could mean it would lose its security interest in the licensed intellectual property rights as well as the pre-print materials if it became unperfected. Unlike the "no new filing" rule for pure licenses, the Lender would be required to make new filings to maintain perfection in case the goods were transferred if the security agreement covered both intellectual property and goods.

To avoid this result, the legislature should consider replacing PPSB §105(1) with a provision consistent with Recommendation 243 from the UNCITRAL Guide discussed above.

6. Priority of the Security Interest:

Once the Lender perfects its security interest, it wants to ensure that so doing gives it priority over competing claimants. For intellectual property, the other competing claimants are other transferees: *e.g.*, prior transferees in the chain of title; other secured creditors of the Producer; other transferees from the Producer; and, other general creditors who execute on a judgment and obtain a court ordered transfer. Intellectual property law already has existing rules that deal with these priority conflicts. The PPSB proposes to adopt new priority rules for some, but not all, of them. This is another area of potential conflict.

a. Priority Policies

A security interest is, by definition, a *property* right which can take priority over other intellectual *property* rights upon foreclosure. Thus, a security right falls within the set of transfer of intellectual property. But the priority rules in the PPSB differ from those in intellectual property law. Under intellectual property law for patents and trademarks, priority is determined by first in time unless the later transfer is to a bona fide purchaser. For copyrights, the first in

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time prevails except for filings in the companies register. For the PPSB, priority is determined by first to file regardless of knowledge. Moreover, the PPSB allows a "super-priority" for an "ordinary course" transfers even over a recorded security interest. This can lead to conflicts.

In addressing this problem, the UNCITRAL Legislative Guide proposes that for property subject to specialized registries, e.g., patents or trademarks, a secured party should be able to perfect by filing in the specialized intellectual property registry (Recommendation 38). Such a filing would take priority over any filing in the general security rights register whenever made (Recommendation 77). It would also take priority over later transferees and licensees (Recommendation 78) in accordance with priority rules for the specialized registry (Recommendation 4(b).) The priority issue has been discussed in the IP Annex, which endorses this approach and suggests the Guide's priority rules would defer to "bona fide purchaser" rules for security rights in specific assets. WP. 39-Add.2 ¶ 51 (applying Recommendation 4(b)).

<u>The legislature may wish to consider adopting the priority approach in the UNCITRAL Guide for trademarks and patents.</u> Under the PPSB, the Register will likely use the identification given by the intellectual property offices as the "serial number." Thus, a lender seeking to encumber all of a grantor's trademarks or patents would need to file a registration that listed all of them by serial number. Under current practice, the lender files a mortgage in the trademark or patent office that also listed all the applicable intellectual property. The mechanics are not much different. It is not obvious that filing in the PPSB register has any administrative or cost advantage over continuing to use filings in the applicable intellectual property registers. However, using the patent and trademark filing offices means using their priority rules, which avoids potential priority conflicts.

b. Priority Issues – Purchase Money Security Interests

For the Lender, a particularly important issue is ensuring it has priority in claims to the licensor's share of royalty income as against a pre-existing secured lender of the licensee.

On this point the PPSB takes an exceptionally beneficial approach. PPSB § 14(1)(b) defines a "purchase money security interest" to include a security interest " taken in collateral by a person who gives value for the purpose of enabling the grantor to acquire rights in the collateral to the extent that the value is applied to those rights." As we understand it, this would allow a licensor of intellectual property, or its Lender, to obtain a "purchase money security interest" in licensed intellectual property if the licensed intellectual property is treated as "value" given to allow acquisition of the rights. Under PPSB § 62, the purchase money security interest has priority over a competing security interest granted by the licensee if it is registered with 10 business days of the transfer. This priority should also apply to the proceeds, i.e., the licensor's royalty share of the licensee's exploitation income. *This is an extraordinarily beneficial and commercially reasonable rule* especially for copyrights.

Under current law, an intellectual property owner can often obtain a *de facto* priority over a licensee's pre-existing secured creditor. This is because a mortgage or fixed security given to the licensor's Lender takes priority over a pre-existing floating charge against the license. In making the license, the licensor as a timing matter can always make sure its fixed mortgage is in place before the license is concluded, so that any fixed charge by the licensee is later.

The initial draft of the UNCITRAL Guide limited purchase money security (called "acquisition security rights" in the Guide) to tangible goods. The next session of the IP Annex will discuss extending the concept (called "acquisition security rights" in the Guide) to

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intellectual property licenses and related royalty proceeds. WP.39-Add.3 ¶¶ 15-19. This result has come about in no small part due to the persistence of Australia in emphasizing the commercial benefits of applying the "purchase money" concept for intellectual property. **We fully support this approach and applaud the Australian delegation on its tireless support for this crucial concept**.

(In the United States, the 2001 revision to the secured financing law eliminated purchase money rights for intellectual property. This was done over intense objection from intellectual property interests and has been a source of tension ever since. On this point we believe that Australia has taken a much more modern and commercially reasonable approach.)

c. Priority Issues – Ordinary Course Transfers

For the Lender, another issue will be priority over "ordinary course" transferees from the Producer. PPSB § 46(1) says a "buyer or lessee of personal property takes the personal property free of a security interest given by the seller or lessor, or that arises under section 32 (proceeds – attachment), if the personal property was sold or leased in the ordinary course of the seller's or lessor's business of selling or leasing property of that kind." This does not apply if the buyer or lessee has actual knowledge that so doing breaches the security agreement. PPSB § 46(2). An "ordinary course buyer or lessee" takes free of a prior security interest even if it is perfected.

In the usual case, intellectual property is *licensed*, not "sold or leased." As such, this rule would not apply, at least to "pure" licenses (and, one hopes, partial assignments). This is a welcome clarification. Indeed, the "ordinary course" principle has been the subject of intense debate in drafting the IP Annex. Intellectual property interests have uniformly maintained that the concept has no application in intellectual property practice. Indeed, in the view of some parties (including us), an "ordinary course" exception to a security interest in intellectual property is incompatible with international obligations, especially TRIPS. The current draft of the IP Annex therefore proposes severely limiting the concept. WP. 39-Add.3 ¶¶ 7-14.

However, it is still necessary to consider PPSB § 105(1). As discussed above, it treats certain security rights regarding intellectual property rights "in relation to goods" in the same way it applies to goods. How does this apply to copies of intellectual property, especially DVDs, internet downloads, and other copies directed at end users? As discussed above, this would appear to create an "ordinary course" exception to a security interest *in the intellectual property* if the security interest also covered "related" goods.

This is yet another reason why we suggest deleting PPSB § 105(1) entirely.

d. Priority Issues – Execution Creditors

A small but crucial point is priority over "execution creditors." PPSB § 74 says that an "execution creditor" has priority over an unperfected security interest commencing when the collateral is "seized" or "an order is made by the court in respect to the judgment in relation to the execution creditor." We raise this point, again not as an academic exercise, but because it has been the subject of litigation in other countries (*e.g.*, the US and Canada).

In our example, the Lender must conduct due diligence to discover whether there are prior transfers that might take priority over its proposed security interest in the motion picture collateral. What happens if there is a prior judgment and execution against the Producer or a prior transferee in the chain of title? Properly speaking, intellectual property is not subject to "seizure" on execution. This is because the statutes require a transfer by an instrument in writing

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signed by the owner or authorized agent. The proper approach is for the court to appoint a receiver who makes a written transfer "on behalf of" the intellectual property owner as judgment debtor. This transfer then becomes one like any other transfer.

For patents and trademarks, this judicial sale transfer does not gain priority over other bona fide purchasers unless recorded in the applicable trademark or patent offices. This means a secured creditor searching their chain of title can be confident that if no judicial deed is recorded in the relevant intellectual property office it is ineffective against the Lender. PPSB § 74 now appears to reverse this rule. It says that the execution sales transfer – unlike any other transfer – has priority against an unperfected security interest, *e.g.,* a pending production loan, as soon as it is entered in the local courthouse. This means that the Lender must now search every local courthouse to find such a judicial deed to ensure thorough due diligence. As mentioned, this has led to litigation in other countries, and conflicting decisions between the secured financing (bankruptcy) and intellectual property courts.

For copyrights, this risk exists under current law. But why extend it to patents and trademarks? We suggest a simple clarification that, for intellectual property, an execution creditor can gain priority like any other transferee of the intellectual property.

7. Choice of Law Rules:

Another issue for a motion Lender is the choice of law rule. Under the international conventions, intellectual property is subject to the territorial principal, or meaning that the choice of law rules is usually formulated as the "law of the protecting country." While this issue is still under discussion in the drafting of the UNCITRAL IP Annex, intellectual property professionals generally believe that this means the following: while the contractual terms of a security agreement are subject to contract choice of law rules, provisions that lead to enforcement of an intellectual property security right against third parties (such as means of attachment and priority) would be subject to the territorial principle.

In this regard, PPSB § 239(3) provides that a security interest in intellectual property law is governed by the laws of the jurisdiction (other than choice of law rules) under which the intellectual property or license is granted. The exclusion of choice of law rules is evidently meant to exclude *renvior*, although this concept does not apply in the international intellectual property conventions, as it is effectively excluded by the territorial principal. The reference to where the intellectual property is "granted," while slightly different than the traditional "is protected" formula, will probably lead to the same results. Reference to where the "license" is granted presumably means the licensed rights not the license contract. As such, the PPSB on this point should conform to traditional commercial expectations in intellectual property practice.

8. Conclusion:

The PPSB represents an extraordinary effort in organizing, clarifying and modernizing a very diverse and difficult body of law. The Minister and most especially the Draftsman should be congratulated on a superb effort. So doing requires harmonizing a significant number of diverse laws, financing practices, and commercial expectations. Our association represents parties involved in "specialty" lending for high value assets operating under their own specialized body of property law. In commenting on the PPSB, we do not wish to detract from its many significant enhancements to existing law. We merely desire to illustrate how it might

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be adjusted to address our specialty lending practices. We recognize that any legislative reform requires balancing a number of competing interests and policy goals. Our job is to present the legislature with observations that we believe best represents the interests of our members and, we hope, the entire community.

To briefly summarize our views, we would offer the following suggestions:

- PPSB § 10: Clarify that the definition of *license* includes a partial assignment of intellectual property operating like an exclusive license.

- PPSB § 14(1)(b): If there is *any doubt* that this section does not allow a purchase money security interest for intellectual property, clarify it to make sure it does. Continue to support purchase money rights for intellectual property. ***Keep this provision.***

- PPSB § 21(2): Allow a security interest in intellectual property subject to a specialized registry, *e.g.* trademarks and patents, to be perfected by recording in the applicable specialized registry.
- PPSB § 74: Clarify that an execution creditor who obtains a transfer of the intellectual property rights can gain priority like any other intellectual property transferee.

- PPSB § 79(1): Clarify this section either by: (i) excluding transfers of intellectual property from its effect; or (ii) limiting its scope solely to "negative covenants" in security agreements that restrict further grants of security rights.

- PPSB § 105(1): Remove entirely.

- PPSB § 105(2): Replace with a section as in UNCITRAL Recommendation 243 to the effect that, unless otherwise provided in the security agreement, a security right in intellectual property does not extend to associated tangible assets, and a security right in tangible assets does not extend to intellectual property. However, this does not limit whatever rights a secured creditor may have to dispose the tangible assets consistent with intellectual property law.

Thank you for allowing us to provide these remarks. If we can provide any further information, please let us know.

Respectfully submitted by,

Independent Film & Television Alliance