Recordation of Security Interests in IP Rights

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Our high-tech economy places increasing value in intellectual property – primarily consisting of patents, trademarks, copyrights and trade secrets. For many companies, both high-tech and not, their principal assets subside in their intellectual property.

With a roaring economy and ever-greater financial miracles wrought by high-tech companies, most executives and their business partners focus on success. Yet, each new wave of technology includes troubled and failed companies. Often these are companies which could not secure critical funding, or which failed to earn adequate profits. Sometimes this means a reorganization or dissolution under the Bankruptcy Act. Notwithstanding a company's financial condition, its intellectual property often remains valuable. Indeed, for many companies in bankruptcy, dispensation of their intellectual property provides substantially the only source of payment for the debtors.

With so much value placed in the intellectual property, secured parties must ensure that they properly record their security interests. The secured parties typically include lenders, landlords, equipment lessors and other creditors. Some time ago, the courts considered where security interests in copyrights and trademarks should be recorded. Recently, the courts considered where security interests in patents should be recorded.

In the recent case, *In re Cybernetic Services, Inc.*,[1] a high technology company (Cybernetic) was in Chapter 7 bankruptcy (liquidation). Cybernetic's primary asset was a patent.[2] One of Cybernetic's creditors asked the bankruptcy court for the patent. Not surprisingly, the bankruptcy trustee for Cybernetic wanted it, too.

One might wonder why these parties were fighting for the patent. The Cybernetic patent was relatively new. The patent relates to detection of data embedded in a video signal (e.g., a television program). With the convergence of video and data technologies, the Cybernetic patent potentially relates to quite a few existing and emerging markets. Patents remain in effect for about 17 years,[3] and even after they expire, can be enforced for past infringement. Technology and markets develop over time, and it often takes years for a technology market to become successful. Because of the need for backwards compatibility and the low cost of retaining even outdated technologies in products, once a

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[1] *In re Cybernetic Services, Inc.*, 52 USPQ2d 1683 (9th Cir.) (1999).

[2] Patent No. 4,620,227, issued October 28, 1986, and expiring October 28, 2003.

[3] The Patent Act currently provides that a patent expires 20 years from its filing date. Based upon an average pendancy of three years, a 17 year term results. Some patents also qualify for a guaranteed 17-year term, and pending legislation will extend this guarantee to all patents. Irrespective of the patent's term, the Patent & Trademark Office must be paid fees to maintain the patent rights. These "maintenance" fees are due about every four years from the patent's grant. For some older patents, maintenance fees are never required.

technology is established, it rarely disappears entirely from the market. Thus, patents such as the Cybernetics patent often have relevance even in their final years.

One of the authors has direct experience in this. Several years ago, he assisted a client in purchasing a patent from a trustee in bankruptcy. The patent had just a few years left in its term. The purchase price was relatively low – under $10,000. Through careful enforcement efforts, the patent generated millions of dollars in license fees in about two years, almost all of which was profit.

Returning to *Cybernetic*, the issue was whether the creditor had superior rights to the patent than the trustee in bankruptcy. The creditor had a blanket security interest in all of Cybernetic's assets, including general intangibles. The creditor and the trustee agreed that this was sufficient to create a security interest in the patent. A UCC-1 financing statement and a UCC-2 continuation statement covering, amongst other things, the debtor's general intangibles was properly and timely filed with the California Secretary of State. However, there was no filing of a financing statement or any other document with the Patent and Trademark Office. The creditor argued that recordation with the Secretary of State perfected its security interest, and therefore it was due the patent.

The trustee in bankruptcy, however, claimed that the creditor had not perfected its security interest in the patent. According to the trustee, the security interest in the patent should have been recorded in the Patent & Trademark Office. If so, then the creditor would not have the superior claim to the patent. After the bankruptcy court granted the creditor a stay of relief (i.e., the lower court thought the creditor should have the patent), the trustee appealed.

The parties agreed that if the security interest was perfected the creditor would be entitled to stay relief because the bankruptcy estate would have no equity in the patent. They also agreed that if a Patent and Trademark Office filing was required to perfect the lien, the trustee's hypothetical creditor rights would trump the creditors' security interest. Thus, the Bankruptcy Appellate Panel (BAP) had to decide whether the creditors' security interest was perfected.

First, the BAP determined that the Patent Act [*see* 35 U.S.C.A. § 261] did not preempt Article 9 of California's UCC. The Patent Act provides that "an interest in a patent is assignable and an assignment is void against a subsequent purchaser or mortgagee without notice of the assignment, unless the assignment has been recorded in the Patent [and Trademark] Office." Thus, the question was whether the term "assignment" in the Patent Act includes the grant of a security interest and whether every secured party and lien holder is a "mortgagee" under the Patent Act. If the answer to these questions was yes, then the Patent Act would effectively control the perfection of security interests and liens in patents.

The BAP held that an "assignment," as used in the Patent Act, is a transfer of title. Under 37 C.F.R. 3.11(a), assignments accompanied by a cover sheet will be recorded and other documents affecting title will be recorded at the discretion of the Commissioner. In 37 C.F.R.11, an assignment is defined as a transfer by a party of all or part of its right, title and interest in a patent or patent application. The terms "security interest" and "lien" are not included in any of the federal laws or regulations governing patents. This omission had to be contrasted, the BAP reasoned, with other federal statutes that expressly include security interests and liens within their scope -- such as the Copyright Act. To the extent that the Copyright Act regulates security interests, it preempts state methods of perfecting security interests. However, the "failure of the Patent Act to include security interests within the scope of its regulation leads to the opposite conclusion; the Patent Act does not preempt state regulation of security interests in patents."

Next, the BAP concluded that the existence of the Patent and Trademark Office filing system did not exclude patents from the Article 9 perfection requirements. The trustee's exclusion arguments were based on West's Ann.Cal.Com.Code § 9104(a) and West's Ann.Cal.Com.Code § 9302(3)(a). Under § 9104(a), Article 9 does not apply to a "security interest subject to any statute of the United States to the extent that such statute governs the rights of parties to and third parties affected by transactions in particular types of property." Under § 9302(3)(a), a financing statement is not necessary or effective to perfect a security interest in property subject to "[a] statute or treaty of the United States which provides for a national or international registration or a national or international certificate of title or which specifies a place of filing different from that specified in this division for filing of the security interest."

Official Comment 8 to UCC § 9302, the BAP noted, refers to three federal statutes that provide a filing system adequate to supersede the Article 9 filing system for perfection of security interests: (1) 17 U.S.C.A. §§ 28, 30 (copyrights), (2) 49 U.S.C.A. § 1403 (now, § 44107) (aircraft), and (3) 49 U.S.C.A. § 20(c) (now § 11301) (railroads). "Each of those statutes clearly includes the filing of security interests within their scope, each requires that a security interest be filed within the applicable registry to obtain priority and perfection of a security interest, and each provides that a filing provides constructive notice of the security interest."

"In contrast the Patent Act is not sufficiently comprehensive to exclude state methods of perfecting security interests in patents. The Patent Act does not include security interests within any of the scope or definition provisions. Security interests in patents are not assignments governed by the mandatory recording provisions of § 261 of the Patent Act. Because the Patent Office records security interests on a discretionary basis and such recording does not provide constructive notice, the Patent Act registration system is insufficient to provide the sole method of perfecting security interests in patents."

Notwithstanding the BAP's thoughtful analysis, the authors continue to recommend a conservative, multiple-filing approach. That is, a security interest in a patent should be recorded both with the secretary of state and the Patent & Trademark Office, and in the county recorder's office if possible. We have similar recommendations with respect to copyrights and trademarks.

We have four reasons. First, there is a continuing risk that the holding of the *Cybernetic* court and other courts will be reversed. Second, the holding of the court in *Cybernetic* is controlling precedent only in the 9^{th} Circuit – California, Arizona, Oregon, Washington, Montana, Idaho, Nevada, Alaska, Hawaii, Guam and the Northern Mariana Islands. That leaves 41 other states where the issue remains open. Third, by recording in multiple places, the trustee in bankruptcy will not have the opportunity to argue the issue. Fourth, either Congress or a state legislature may change their laws, and thereby undermine the basis for *Cybernetic* and other holdings.

Both creditors and trustees should ensure that proper steps are taken to preserve debtors' intellectual property assets. For patents, this means paying maintenance fees (about every four years). For trademarks, this means continuing their use, filing a statement of continued use and obtaining renewals. For copyrights, this means obtaining renewals. The creditors' and trustees' should not limit their concerns to intellectual property rights which the federal government has acknowledged. A bankrupt estate often includes patentable inventions, unregistered trademarks and unregistered copyrights. Because of various statutory and practical time limitations, failure to timely file for federal intellectual property protection can result in a loss of rights. Because troubled companies often focus only on short-term self-preservation, trustees and creditors should consider identifying debtors' intellectual property assets and paying for patents and trademark and copyright registrations as a way of preserving and enhancing bankruptcy estates.

It will be interesting to see if the Cybernetic patent finds further fame. One can imagine Cybernetic's creditor earning far more from the patent than from its bad loan.