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Note

PRIORITY DISPUTES INVOLVING SECURITY INTERESTS IN PATENTS: CASE LAW AND CURRENT PROPOSALS

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I. General Introduction

In spite of the economic value of patents, copyrights, trademarks and trade secrets, the use of such intellectual property¹ as collateral for securing loans has been relatively rare until recent years.² One of the primary reasons for this trend is lenders' reluctance to accept such collateral because of perceived legal uncertainty with regard to their rights in the event of default.³

While Article Nine of the Uniform Commercial Code ("UCC") is drafted broadly enough to include intellectual property within its definition of "general intangibles," it is also provided elsewhere in the UCC that secured transactions involving such property are excluded from its perimeters to the extent that federal statutes exert control over these forms of property.⁴ Of particular significance are *258 the UCC provisions that relate to perfection of security interests by filing.⁵ These provisions, in spirit, take a deferential approach to the filing mechanisms provided for intellectual property under respective federal statutes.⁶ The relevant UCC language and comments, however, do not provide a clear picture of the scope and depth of federal preemption.

One obvious aspect of uncertainty that arises from this confusion is that the lender is not reasonably confident in perfecting his security interest in intellectual property. A lender's decision to accept a borrower's intellectual property as collateral depends largely on his ability to enforce the security agreement against both the borrower and any potential third parties in the event of loan default. Thus proper recordation of the interest is essential to perfect the lender's rights.⁷ Unfortunately, the interface between the UCC and the federal law does not provide sufficient guidance to the lender in this crucial aspect of the transaction.⁸

Several scholars have recently addressed -- and lamented over -- various problems caused by such a fuzzy legal landscape in this important area of secured financing.⁹ The consensus that appears to emerge from this scholarship is that while federal law

“clearly” preempts the Article Nine provisions for filing respecting intellectual property, the incidents of perfection are still governed by the UCC.¹⁰ Furthermore, in order to inject legal certainty several modifications to the extant body of law -- both federal and the UCC -- have been proposed.¹¹ The result is supposed to provide a more reliable federal recordation scheme for interests in intellectual property.

There is one disturbing aspect to this enterprise, however. A cursory survey seems to indicate that for the most part the extant case law that deals with priority contests involving intellectual property interests seems to go the other way.¹² That is, most courts presented with such questions use and support the state filing system for intellectual property as well.

***259** The aim of this note is to present a thesis that the case for a federal filing system is not all that clear and any implementation of the so-called federal alternatives should proceed only with informed caution. To limit the scope of this presentation to a manageable level, the focus of this note is on only a particular form of intellectual property -- patents. First, this note presents an overview of the pertinent case law. This section is followed by a broad analysis of the interplay between Article Nine and the Patent Act.¹³ Further, this note analyzes in depth two recent proposals addressing security interests in patents.¹⁴ Lastly, this note concludes with a discussion on some of the challenges that must be met in the process of adopting any proposal.

II. Development of the Case Law

One of the earliest decisions dealing with the interpretation of the recordation provision of the Patent Act came from *Waterman v. McKenzie*.¹⁵ Waterman, an infringement action, arose from multiple transactions all of which involved a single patent on an improvement in fountain pens. The court had the unenviable task of determining the rights of the parties who had engaged in a complex series of transactions.¹⁶ Construing that the Patent Act provided for only two ways of transferring an interest in a patent, via assignment or license,¹⁷ the Waterman court eschewed recognizing creation of security interests as currently understood within the framework of Article Nine. A logical implication of this construction is that a lender cannot take out a “security interest” in patents via the federal provision unless such a transfer is molded to fit the definition of an assignment or a license.¹⁸ Another possibility is that the laws governing security interests in patents lie completely outside the scope of the federal statute. It will be sufficient, therefore, for the lender to comply with the Article Nine filing provisions for perfecting a security interest in patents.

In 1973, *Holt v. United States* took precisely this position.¹⁹ There, the creditor had taken a security interest in different types of collateral including patent applications. The perfection was *260 accomplished by local filing under Article Nine.²⁰ The debtor subsequently assigned the patent applications to a third party.²¹ The *Holt* court determined that the Article Nine creditor had perfected his interest against the third party assignee. In so doing, the court ruled that the secured creditor was not required to file in the United States Patent and Trademark Office (“PTO”) for two reasons: first, there was no assignment of title involved in the secured transaction with the creditor. Second, the language of the relevant provision in the Patent Act²² did not refer to security interests *per se*.²³

A threshold issue is whether there is an absolute requirement of federal filing for a creditor who takes an interest in patents. If the answer is no, a corollary concern is what its legal effect might be on his rights as against third parties. In a more recent setting, the court in *In re Transportation Design & Technology, Inc.*, confronted these issues.²⁴ There, the creditor took a security interest in “all general intangibles” of the debtor which included a patent, and filed a financing statement with the secretary of state.²⁵ However, he did not file with the Patent and Trademark Office.²⁶ After the debtor filed for bankruptcy, the trustee sought to avoid the creditor’s interest in the patent under the federal Bankruptcy Act²⁷ claiming that the creditor was not perfected because he had failed to comply with the federal requirements.²⁸ On the other hand, the Article Nine creditor argued that because the federal law was silent about the status of a lien creditor, it could hardly be invoked to support the trustee’s claim.²⁹ The court agreed, holding that because a trustee in bankruptcy is neither a subsequent purchaser for value nor a mortgagee but is rather in a position of a hypothetical lien creditor, a contest between a trustee and the creditor is not governed by federal law. Finding no conflict between state and federal law, the court concluded that the UCC governs such priority contests.³⁰

In one important aspect the *Transportation Design* court narrowed the reach of the *Holt* decision. Under *Holt*, an Article Nine creditor who has not filed in the federal office can still defeat a subsequent assignee. The *Transportation Design* court, on the other hand, concluded that although a UCC filing is sufficient to protect a creditor’s interest as against a hypothetical lien creditor, it offered no immunity from a bona fide purchaser for value or a mortgagee. It went on to explain that:

the secured creditor [who] wishes to protect itself against the debtor transferring title to the patent to a bona fide purchaser or mortgagee who properly records must bring its security interest (which is not ordinarily a transfer of title) within the provision of the Patent Act governing transfer of title to patents.³¹

The *Transportation Design* analysis was followed in 1988 by *City Bank and Trust Co. v. Otto Fabric, Inc.*³² where the decision turned on whether perfection of a security interest was achieved under the federal or state law. The creditor, having entered into a security agreement with the debtor on January 4, 1985, filed a financing agreement with the secretary of state. On January 11, the debtor *261 assigned all its title and interest in the same patents to the creditor pursuant to the assignment provision of the Patent Act. The recordation of this transfer in the Patent and Trademark Office did not occur until January 19, 1985.³³

The debtor, after filing for Chapter 11 bankruptcy on April 8, 1985, sought to avoid its transfer of patent rights to the creditor as a preference under the theory that the transfer was perfected only as of the date of federal filing which fell within the 90-day period.³⁴ Echoing *Transportation Design*, the court concluded that federal filing was not required to perfect a security interest in patents as against the trustee, and hence, the creditor's interest, perfected outside the 90-day period, was protected from the trustee's preference attack.³⁵ The court, however, did not reach the issue of whether federal filing is necessary to perfect a security interest in patents against subsequent purchasers and mortgagees.

The latest decision consistent with this line of doctrine is *Chesapeake Fiber Packaging Corp. v. Sebro Packaging Corp.*³⁶ There, the inventor/assignor (Sebro), assuming, in a perverse twist, the role of a subsequent purchaser, argued unsuccessfully to void the judgment sale of its patent application that had been transferred to its assignee (Majestic). Majestic, as a debtor, procured loans from the creditor (Sovran) which took an interest in the patent application under the rubric of "all general intangibles" which specifically included patents and future contract rights. Only state and county filing was done pursuant to Article Nine.³⁷

Majestic subsequently defaulted on its obligations to Sovran. The bankruptcy judge entered a Consent Order which authorized Sovran to repossess and dispose of all collateral.³⁸ Pursuant to the procedure set forth in the Consent Order, Sovran sold its security interest in the patent application to the competitor (Chesapeake) of Sebro that sought to contest the transfer of interest. Sebro asserted two pertinent grounds: first, the assignment of the patent application from Sebro to Majestic was ineffectual because Majestic breached the assignment agreement, and second, because only federal filing provisions were sufficient to perfect a security interest in patents the creditor did not have a valid interest in the first place that could be resold.³⁹ The court disagreed, reasoning that it was sufficient for the creditor to file locally and that Sebro was not a bona fide subsequent purchaser for value.⁴⁰ Further, it found that, as a matter of law, Chesapeake was the lawful owner of the patent, and therefore, it could sue Sebro for infringement. An appeal was taken and the Fourth Circuit affirmed in November, 1993.⁴¹

*262 Several things emerge from the foregoing survey of the pertinent case law. First, there are two apparently parallel recordation schemes available for transactions that have an effect on the "bundle" of property rights associated with patents. The courts that have had occasion to examine the interplay between these two schemes seem to concur that an Article Nine creditor who has duly filed according to the requisite provisions wins in a contest with a trustee in bankruptcy. Further, at least one court has held that his interest is superior to that of a subsequent assignee.⁴² Lastly, the courts, by not addressing potential contests between parties that assert rights under either of the two regimes, have refused to accept the invitation to delineate the boundary between the two.

In the next section, this note reviews the two systems of recordation for patents⁴³ and the recent proposals that aim to remedy the problems that arise from the conflict between them.⁴⁴ These proposals recommend a federal alternative for taking out a security interest in patents. This note analyzes the proposals and point out a few pitfalls that may be lurking around if a "federal" approach is adopted. Further, in conclusion, this note attempts to make a case, at a minimum, for status quo with further research in this area.

III. Security Interests in Patents

A. Provisions under the Patent Act

The Patent Act of 1952, as amended, does not include an explicit provision for regulating security interests in patents.⁴⁵ The legislative history is silent with respect to whether the Act's assignment provision encompasses security interests.⁴⁶ While the Senate Committee report notes that the current assignment provision was substantially derived from the previous statute, it fails to trace its history.⁴⁷ Legislative silence in this regard may mean that Congress simply did not contemplate -- hence, it could not have intended -- potential collateralization of patents under the assignment provision. Or, it may also mean that although Congress did consider this matter, it subsequently felt that it was not necessary to provide for security interests in patents under the assignment provision because they were treated elsewhere.

Section 261 of the Patent Act, as amended, regulates transfer of interests in patents. It states:

An assignment, grant or conveyance shall be void as against any subsequent purchaser or mortgagee for a valuable consideration, without notice, unless it is recorded in the Patent and Trademark Office *within three months from its date* or prior to the date of such subsequent purchase or mortgage.⁴⁸

This provision resembles nineteenth century chattel mortgage statutes⁴⁹ which were designed to authorize *263 recording as an alternative to the secured party's taking a pledge of the collateral to preserve the secured party's interest in the collateral against third parties. The federal law further resembles chattel mortgage legislation to the extent that § 261 provides a filing grace period of three months.⁵⁰

The federal regulations implementing § 261 provide for mandatory recordation of patent assignments.⁵¹ Once recorded, a patent assignment is valid against subsequent purchasers and mortgagees for value. Underlying this system of filing is the notion that one makes public the actual transaction in which the "owner" transferred an "interest" in the intellectual property. It functions not only to record who has interests in the property but also to document for the owner the "metes and bounds" of the patent owner's monopoly. What is important under the federal system is who has an interest in the property, not who *might* have an interest.⁵²

On its face, § 261 covers only "assignments," "grants" and "conveyances" and for these transfers it establishes a priority system only as against later purchasers and mortgagees. Under this scheme, to file there must be a transfer of ownership in the form of an assignment or mortgage.⁵³

A "security interest" is not an "assignment, grant or conveyance" of a patent.⁵⁴ It is important to remember that the patent law adheres to strict concepts of title, in order to protect the ownership of new inventions. It therefore distinguishes "assignments" of patents (of which "grants" and "conveyances" are specific types) from all other transfers (which are called "licenses").

An assignment is the outright transfer of all (or an undivided portion) of the patentee's exclusive rights to make, use and sell an invention throughout the United States.⁵⁵ It also includes the rights to further assign and to sue for infringement. Unlike assignments, licenses do not represent a transfer for any property interest in the patent. Rather, a license is merely a promise of one having an interest in the patent not to sue one who, but for the license, would be an infringer. In a sense, the license represents a sharing of rights under a patent rather than a transfer. If the license agreement does not expressly forbid the licensor to license to others, the license is non-exclusive.

B. Article Nine Considerations

One of the areas of greatest confusion relating to the use of patents as collateral concerns the method of perfecting security interests therein.⁵⁶ Ordinarily, perfection is accomplished by the filing of a UCC-1 financing statement with the appropriate state or local office.⁵⁷ Although the UCC does not clearly indicate whether state or federal law governs perfection of interests in patents, the issue is addressed in several places. The "excluded transactions" provision, § 9-104 states that "[Article 9 of the UCC] does not apply (a) 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 *264 types of property."⁵⁸ The Drafters in the comments to that Section explain that:

Although the former Federal Copyright Act contains provisions permitting the mortgagee of a copyright and for the recording of an assignment of a copyright . . . such a statute would not seem to contain sufficient provisions regulating the rights of the parties and third parties to exclude security interests in copyrights from the provisions of this Article.⁵⁹

Taken together it seems clear that if a federal statute is "sufficient" within the meaning of § 9-104, a security interest in that property is controlled by federal law and is completely excluded from Article Nine.

On the other hand, Comment 8 of the filing provision § 9-302,⁶⁰ which at first blush appears to contradict § 9-104, states that:

Subsection (3) exempts from the filing provisions of this Article transactions as to which an adequate system of filing, state or federal, has been set up outside this Article and subsection (4) makes clear that when such a system exists perfection of a relevant security interest can be had only through compliance with that system (i.e., filing under this Article is not a permissible alternative). Examples of this type of federal statute referred to in paragraph (3)(a) are the provisions of the [former Copyright Act] . . .⁶¹

Although it has been argued that the comments to sections 9-104 and 9-302 are in conflict,⁶² it seems that these two provisions address different concerns altogether. The former goes to a federal statute that so completely preempts the field of filing and priority resolution that a secured transaction involving that property is excluded from the scope of Article Nine. On the other hand, to the extent a federal statute provides an adequate filing mechanism and no more, there is only a partial preemption of Article Nine. Thus, ultimately, the issue is to what extent the Patent Act provides an “adequate” system of filing for documents concerning security interests in patents. Implicit in this inquiry is the question of what is the proper frame of reference (or, to put it in practical terms, what type of lenders are we talking about) to determine this adequacy.

IV. Analysis of Recent Proposals

Two recent developments⁶³ in the field of patent collateralization have attempted to address and resolve the apparent conflicts that arise from the interplay between the parallel recordation schemes for perfecting security interests in patents. One of the primary goals of these efforts is to arrive at a scheme that is inexpensive, fairly predictable, yet geared to a fast-paced economic system.

***265** Klumb starts with an eye towards practicality by saying that the safest approach is to file under both federal and state laws when securing a loan with the debtor’s intellectual property. Subsequently, Klumb notes there are various economic costs associated with such dual filing, although the proposal does not address potential legal ramifications of dual filing. Finally, Klumb briefly notes the putative economic advantages and states a proposal.⁶⁴

The main recommendation of the Klumb article is that Congress should amend the Patent Act to clarify that the federal recording provisions preempt Article Nine filing requirements within the meaning of section 9-302.⁶⁵ Further, the article suggests language to be appended to 35 U.S.C. § 261: “Filing under this section is the sole method of perfecting a security interest in a patent notwithstanding state law to the contrary. All issues other than perfection of such a security interest remain subject to state law.”⁶⁶ The proposal goes on to add more textual modifications to the Official Comments to sections 9-104 and 9-302 essentially clarifying the same position. Klumb recommends that Comment 1 to section 9-104 should read: “[T]he Patent, Copyright and Trademark Acts do not contain sufficient provisions regulating the rights of the parties and third parties to exclude security interests in such property from the provisions of this Article. The filing provisions of these federal statutes, however, are recognized as the equivalent of filing under this Article. See sections 9-302(3) and (4) and the Comments thereunder.”⁶⁷

The proposed modification to Comment 8 to section 9-302 is to read: “[T]he federal Patent, Copyright and Trademark Acts are the type of statute referred to in section 9-302(a). The filing of a financing statement under the UCC is ineffective to perfect a security interest in federally registered patents, copyrights or trademarks. See 35 U.S.C. § 261 (patents);”⁶⁸

Klumb asserts that the result of this proposal is that a creditor who desires to take a security interest in patents under Article Nine would be alerted to the preemptory effect of the federal law and therefore would file in the “right” place.⁶⁹ Another goal of this proposal is to explicitly recognize the partial preemption within the scope of section 9-302 (as distinguished from complete preemption per section 9-104) by the federal law.⁷⁰

Several issues emerge from these recommendations pursuant to the Klumb proposal. One problem is that a “security interest” that is taken under 35 U.S.C. § 261 will have to be modified to take the form of an assignment because this provision does not recognize any other transfer.⁷¹ This clearly runs contrary to the spirit of Article Nine that professes to be form-neutral and title-neutral.⁷² In addition, there is a more fundamental problem with a “security interest” taken as an assignment. The recommended device is termed a “conditional assignment” whereby title is vested in the creditor-assignee, subject to defeasance through reassignment to the debtor-assignor after repayment of the debt. This means that the creditor has essentially become the new “owner” of the patent. He has all the rights and obligations of a rightholder -- “his” patent may be subject to infringement suits,⁷³ interference *266 attacks,⁷⁴ “secret” liens⁷⁵ and possibly any outstanding claims against the assignor that arise from patent matters. It is highly unlikely that a “general” secured creditor would be willing to assume all these legal incidents of a conditional assignment, even though he may take solace in the fact that after his repayment he is relieved of them.

Another significant problem arises in the context of the three-month grace period available for filing under the federal law. Consider the following scenario: On January 1, the debtor/assignor/patentee (“DAP”) makes a regular assignment to Absolute Assignee (“AA”) for value. AA has three months to file in the Patent and Trademark Office (“PTO”). Being slothful (or, knowing that he has “enough” time), AA does not get around to it for a while. In the mean time, DAP needs more cash and agrees to give Big Bank, BB (secured party or conditional assignee) a “security interest” via conditional

assignment. Being diligent -- and forewarned because of Klumb's recommendations -- BB checks the PTO filing system. Seeing nothing there, BB executes the loan and file promptly -- say, January 15. AA finally gets around to filing in the PTO on February 1. As is usual in these types of scenarios, DAP subsequently goes bankrupt.

It is extremely difficult to sort out the ensuing priority contest under the Klumb proposal without knowing beforehand what the precise effect of the "first to file or perfect" system of Article Nine is under these conditions. A straight forward application of the Article Nine rules to such priority contests will be either intractable or inapposite. Operating under the current system of parallel recordation systems, the *Holt* court⁷⁶ at least introduced some degree of determinability of outcomes in this species of transactions.

Moreover, by grafting the notice filing elements of Article Nine on to the transactional filing system of the Patent Act one can only hope for an unfamiliar hybrid -- something that nobody knows exactly what it is or what it entails. It is doubtful whether creditors would be willing to risk their capital when they know that for three months they cannot be sure that their interests are not compromised by "latent" interests. More interesting, and vexing, issues emerge if one extends the three-month grace period to conditional assignments also.⁷⁷ When one thinks of other potential actors involved in these transactions that have gone sour, the ensuing litigation concerning the latent interests due to the grace period will be voluminous.

Further, creditors who typically take intellectual property as an adjunct of the collateral -- not as the "main stuff" -- are still burdened with dual filing and legal uncertainty. While they may be happy to know that they have to file in a federal office with regard to patents, they still have to comply with the UCC filing for other categories of collateral, part of which may well be a different type of "general intangibles." To the extent that these creditors will be required to list separately the security interest (read "conditional assignment") in patents for federal purposes, they cannot take advantage of the boilerplate "all general intangibles" in the filing documents. Moreover, it may force them to subcategorize *267 even other types of intangibles for the state filing unless it is permissible to use something like "all general intangibles except intellectual property" in the financing statements. The extra costs -- legal as well as administrative -- that accompany a "federal only" approach may have a deleterious effect on asset-based financing undertaken by these creditors.

Venture capitalists who finance high-tech startups are a different ball game. To the extent that they are willing to sink seed capital into a venture primarily on the basis of assignment of patents (i.e., they become assignees and license the technology back to the startup along with cash infusions), they may mistake recordation of a conditional assignment as a regular transfer of title and subsequently shy away from a deal. This may produce a "chilling" effect on high-tech financing with concomitant "ripple" effects on the economy as a whole.

A last, but by no means least, consideration that is germane to the Klumb proposal is the time it takes for the federal filing to be entered into the file after submission by the filer.⁷⁸ It is estimated that a delay of about three months in recording patent assignments is not uncommon.⁷⁹ Augmented with the statutory three-month grace period, the total time delay is about six months! In a rapidly moving, competitive economy a startup seeking to use its patents as collateral could go out of business even before a secured creditor could confidently advance a loan.

Asset-based financing is extremely important in a fluctuating economy only to the extent that it can quickly respond to the cyclical demand spikes in money. Long relation-back periods substantially erode this value.⁸⁰ Except where collateral or debtor is moving from state to state, the Article Nine grace periods are kept short partially to alleviate this problem.⁸¹

On the whole the Klumb proposal, while apparently well-intended, is more problematic than it seems. It falls far short of the laudable goals of harmony, legal certainty and cost avoidance. Moreover, it may muddle up more a field that is already murky to begin with.

The Weinberg-Woodward model⁸² attempts to address some of the thorny issues presented in the foregoing analysis. The proposal is similar to Klumb's in that security interests would be perfected by filing a federal financing statement "in an office associated with the Patent and Trademark Office."⁸³ However, a critical distinction is that the priority rules of Article Nine will also be federalized, that is, the UCC rules will be modified suitably to create what the authors call a "federal text." Whether this new body of federal law will be appended to the existing Patent Act or whether it will remain as stand-alone structure is not clear. Another recommendation is elimination of the three-month gap period for security interests in conditional assignment form. The authors also advocate exclusive federal filing for perfection.

In spite of the thorough analysis presented in developing the model, several problems -- conceptual and practical -- remain. One rather obvious issue is the "intra-office" delay⁸⁴ which has to be considered in any priority analysis even without the statutory grace period. Weinberg and Woodward seem to advocate a separate federal office for filing although it is to be

associated with the Patent and Trademark Office.⁸⁵ The method and manner of this “association” is not disclosed, however.

*268 Although the three-month grace period is not available for security interests under this proposal, it will not solve the problem of “latent” assignments which was addressed in the context of the Klumb approach. The secured creditor may be compelled to file as soon as practicable, but he may not be confident that there are no yet-to-be-filed assignments or mortgages on the patents.

Further, the Weinberg-Woodward model is not congruent with the existing case law. To the extent that the proposal requires exclusive federal filing, it will effectively run counter to the *Holt* analysis which is predicated on perfection by state or local filing. Moreover, in a contest between a federal secured creditor and a trustee in bankruptcy the rules are unclear if not downright nonexistent. If the exclusive federal filing is given priority, then the trustee will lose -- a result that is contrary to the current case law.

For instance, let us re-examine the *Chesapeake Fiber* scenario.⁸⁶ There, Sebro could not prevent its competitor Chesapeake from acquiring full title of and all interest in its patent for two reasons. First, Sebro was denied the status of a bona fide subsequent purchaser. Second, since Sovran’s interest was deemed perfected even in absence of federal filing, it was not unlawful for it to resell the rights in the patent application pursuant to the Consent Order following Majestic’s bankruptcy. The court found for Chesapeake precisely because it was able to trace title to it on the basis of Sovran’s perfection.⁸⁷ On the other hand, under the proposal the security interest held by Sovran is necessarily unperfected because there was no federal filing. Therefore, it cannot lawfully resell the rights in the patent application to Chesapeake. Since Chesapeake is no longer the lawful rightholder, it cannot sustain the infringement action against Sebro.

Several of the criticisms that are leveled against the Klumb model can also be directed at the Weinberg-Woodward proposal. Arguably, the twin problems of dual filing and latency in assignments will remain. Moreover, if the security interests in patents are to be recorded as conditional assignments in a separate office with no three-month grace period, there would essentially be three filing systems to search for potential encumbrances.

On a more fundamental level, the so-called federalization of the Article Nine priority rules for contests involving intellectual property has its own constitutional ramifications.⁸⁸ One needs to be concerned about to what extent such a proposal will be permitted within the federalism vis-a-vis supremacy framework. Rich and challenging as it is, this aspect is certainly beyond the scope of this essay.

V. Conclusions and Discussion

It is clear that there is a systemic and conceptual gulf between the state and federal recordation schemes. While Article Nine is form-neutral and title-neutral,⁸⁹ the Patent Act requires both.⁹⁰ Moreover, as a legal system interacting with the external economic system, Article Nine introduces shorter time delays than the Patent Act which allows a longer grace period.⁹¹

It is contended here that the structural differences between the two schemes are largely due to the respective functions they have. The Patent Act has its purpose determination of two things: “owner” of *269 a patent and the “metes and bounds” of the property rights associated with it.⁹² The recordation system thus tracks title with the passage of the bundle of rights. It is a determinable system as to who has title to the patent, not who might have a “secured interest” therein. Having been modeled after the chattel mortgage statutes,⁹³ it retains the cumbersome grace period to accommodate “slower,” or longer-term, transactions involving governmental entities and parties who are in it for the long haul. Venture capitalists, manufacturer-licensees, assignees, other purchasers, typically belong to this pool of third parties.

Article Nine is more geared towards a fast-paced transactional environment with many more private actors.⁹⁴ The debtor under this system is not devoid of the right to alienate his property, subsequent to transfer of a security interest to a creditor. Being free of either form or title,⁹⁵ many such transfers are facilitated using the same collateral. Priority rules are complex and rigorous, with a first-to-file system serving the needs of lenders who are securitizing themselves not on the basis of intellectual property⁹⁶ but on the basis of other, mostly tangible personal property.⁹⁷

Given these rather divergent structures and functions, it is not an easy task to construct a device that bridges the two systems in a seamless fashion. It is not within the scope of this essay to delve into the intricacies of such a task. However, it is reasonable to assert that before any systemic changes are implemented in order to achieve a “federal only” scheme, one should consider some of the potential concerns raised in this paper. It seems clear that there should be further research in this rather complex area to gain a clearer picture of what exactly is needed. If we do go towards a federal alternative, the central question seems to be how to create a security interest under the Patent Act without masquerading it as a conditional assignment with a three-month grace period. A related issue, of course, is: even after we have a device to do what we want,

how we can resolve priority issues involving other § 261 assignments. On the other hand, it may not be a bad idea to ask ourselves first whether the current systems need to be changed at all. Regardless of what a future proposal may be, it is recommended that the existing case law be consistent with it.

Footnotes

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² 1 There are five major forms of intellectual property: Copyrights, patents, trademarks (including trade dress laws), trade secrets and mask works. Of these, only copyrights, mask works and patents are exclusively controlled by federal law. As will be noted later, patents form the primary focus of this article.

³ 2 *See generally* Robert Bramson, *Intellectual Property as Collateral -- Patents, Trade Secrets, Trademarks and Copyrights*, 36 BUS. LAW. 1567 (1981); *see also* Douglas MacLellan, Note, *Security Interests in Intellectual Property: Recent Developments*, 22 GOLDEN GATE UNIV. L. REV. 413 (1992).

⁴ 3 Jeffrey Capwell, Note, *Secured Financing in Intellectual Property: Perfection of Security Interests in Copyrights to Computer Programs*, 39 SYRACUSE L. REV. 1041, 1043 (1988).

⁵ 4 *See* U.C.C. § 9-106 (1992), defining “general intangibles” as “any personal property . . . other than goods, accounts, chattel paper, documents, instruments, and money.” Official Comment to § 9-106 provides: “The term ‘general intangibles’ brings under this Article miscellaneous types of contractual rights used as commercial security. . . . [E]xamples are . . . copyrights, trademarks and patents, except to the extent that they may be excluded by Section 9-104(a).”

Section 9-104(a) provides: “This Article 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.” Official Comment to this Section explains that “[w]here a federal statute regulates the incidents of security interests in particular types of property, those security interests are of course governed by the federal statute and excluded from this Article.”

⁶ 5 *See generally* U.C.C. § 9-302. The scope of the filing provisions of this Section will be discussed in greater detail at a later point in the paper.

⁷ 6 Official Comment 8 to U.C.C. § 9-302 states that:

Subsection (3) exempts from the filing provisions of this Article transactions as to which an adequate system of filing, state or federal, has been set up outside this Article and subsection (4) makes clear that when such a system exists perfection of relevant security interest can be had only through compliance with that system (i.e., filing under this Article is not a permissible alternative). Examples of the type of federal statute referred to in paragraph (3)(a) are the provisions of [the former Copyright Act] *See also infra* note 59.

⁸ 7 *See* Capwell, *supra* note 3.

⁹ 8 *See generally* Harold Weinberg & William Woodward, *Easing Transfer and Security Interest Transactions in Intellectual Priority: An Agenda for Reform*, 79 KY. L. J. 61 (1990).

¹⁰ 9 *Id. See also* Marci Klumb, Note, *Perfection of Security Interests in Intellectual Property: Federal Statutes Preempt Article 9*, 57 GEO. WASH. L. REV. 135 (1988).

¹¹ 10 Klumb proposes a hybrid system whereby filing is done in a federal office and priority issues are governed by Article Nine. The Weinberg-Woodward model recommends a fully federalized scheme. A complete analysis of these proposals is provided in the paper in Section IV. *See supra* notes 8, 9.

¹¹ 11 *Id.*

12 The few cases that address priority contests involving patents stand in general for the proposition that perfection by state filing is superior to a trustee in bankruptcy. The courts, however, have avoided broad pronouncements comparing federal filing to Article Nine filing. *See infra* section II.

13 35 U.S.C. §§ 1-376 (1993).

14 *See supra* note 10.

15 138 U.S. 252 (1891).

16 *Id.* at 253-54. The case describes the transactions as follows:

[1] An assignment, made February 13, 1884, and recorded March 27, 1884, from Lewis E. Waterman, the plaintiff, to Sarah E. Waterman, his wife, of the whole patent and invention. [2] A “license agreement,” made between Mr. and Mrs. Waterman on November 20, 1884, and never recorded, by which she granted to him “the sole and exclusive right and license to manufacture and sell fountain penholders . . .”, [3] An assignment, made November 25, 1884, and recorded November 29, 1884, from Mrs. Waterman to the firm of Asa L. Shipman’s Sons, of the whole patent and invention, expressed to be made in consideration of the patent of the sum of \$6500, and containing this provision: “. . . whereas the said Lewis E. Waterman and the said Sarah E. Waterman have, on this 25th day of November, 1884, made a joint note of hand for the sum of \$6500, payable to the said Asa L. Shipman’s Sons three years from this date, . . . now, if the said Lewis E. Waterman and myself, or either of us, shall well and truly pay the said note, . . . then this assignment and transfer shall be null and void, otherwise to be and remain in full force and effect,” [4] An assignment, made November 25, 1884, . . . from the firm of Asa L. Shipman’s Sons to Asa L. Shipman, of all the right and title . . . , and [5] An assignment, made April 16, 1886, and recorded April 22, 1886, from Mrs. Waterman to the plaintiff of all her right, title, and interest in the patent and invention, and all her claims or causes of action for the infringement of the patent. *Id.*

17 *Id.* at 255. The court said: “[I]t matters not what the instrument is called. It matters not that it may be defeated by the payment of \$6,500 on November 25, 1887.” *See also* 35 U.S.C. § 261.

18 *See* discussion of assignments and licenses *infra*, p. 263.

19 Holt v. United States, 13 U.C.C. Rep. Serv. (Callaghan) 336, 337 (D.D.C. 1973).

20 *Id.* at 337.

21 *Id.* at 338.

22 35 U.S.C. § 261.

23 *Holt*, 13 U.C.C. Rep. Serv. (Callaghan) at 339. The court was “[n]ot convinced by defendants’ argument that a written assignment of the patent application was necessary to create a security interest.” The court, further, said: “35 U.S.C. § 261 is inapplicable because there was no assignment.”

24 *In re* Transportation Design & Technology, Inc., 48 B.R. 635 (Bankr. S.D. Cal. 1985).

25 *Id.* at 637.

26 *Id.*

27 *See* 11 U.S.C. § 544(a)(3) (1984).

28 *Transportation Design*, 48 B.R. at 638.

29 *Id.*

30 *Id.* at 639-40.

31 *Id.* at 640.

32 83 B.R. 780 (Bankr. D. Kan. 1988).

33 *Id.* at 780-81.

34 See 11 U.S.C. § 547(b)(4) (1988).

35 *Otto Fabric*, 83 B.R. at 784.

36 143 B.R. 360 (D. Md. 1992).

37 *Id.* at 365. Sovran perfected its security interest in Majestic's assets by filing financing statements with the State of Maryland Department of Assessments and Taxation and with the Clerk of the Circuit Court for Cecil County, Maryland. In particular, Sovran's financing statements specifically covered "[a]ll of the . . . contract rights . . . and patents now owned or hereafter acquired by the debtor [Majestic]." Sovran, however, did not file with the PTO any notice of its security interest in Majestic's patent rights.

38 *Id.* As of October 5, 1989, Majestic's indebtedness to Sovran amounted to some fifteen million dollars. Both Majestic and Sovran agreed to the entry of this Consent Order.

39 *Chesapeake Fiber*, 143 B.R. at 368.

40 *Id.* at 369. Although Majestic had orally agreed to prosecute the patent application, it later abandoned it when it went into bankruptcy. The patent attorneys for Majestic, who had discontinued all work on the patent application, were subsequently approached by Sebro to revive the application in its name. Sebro, as part of the deal, agreed to pay all outstanding sums due the patent attorneys for the Majestic work.

41 *Chesapeake Fiber Packaging Corp. v. Sebro Packaging Corp.*, 8 F.3d 817 (4th Cir. 1993). A slip copy of the unreleased opinion is available at 1993 WL 441806 (4th Cir. Nov. 2, 1993). This case is further analyzed under a federal filing model, *infra*, as an example.

42 *Holt*, 13 U.C.C. Rep. Serv. (Callaghan) at 339.

43 Both Article Nine and 35 U.S.C. § 261 are analyzed in Section III, *infra*, to delineate sources of possible confusion.

44 See *supra* note 10.

45 The only relevant language concerning transferring interests in patents is provided in 35 U.S.C. § 261. The law recognizes as "assignments" only those transfers of 1) an entire patent, 2) an undivided fractional portion of the patent rights, and 3) all rights embraced in a patent to a specified part of the United States. The assignee takes what amounts to an *ownership* interest. See generally Weinberg & Woodward, *supra* note 8. A patent "grant" is like assignment except that it is limited to a portion of the

country. A patent “mortgage” vests the whole title to a patent in the mortgagee, subject to defeasance by performance of a condition such as the payment of the debt. “Purchaser” refers to persons taking by assignment.

⁴⁶ *See supra* Klumb, note 9.

⁴⁷ *See* S. Rep. No. 1979, 82nd Cong., 2d Sess., Reprinted in 1952 U.S. Code Cong. & Admin. News 2394.

⁴⁸ 35 U.S.C. § 261 (1988) (emphasis added).

⁴⁹ *See* 1 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 16.2 n.3 (1965). Chattel mortgage statutes date back to about 1820 and, as indicated by their name, generally applied only to tangible personal property. *Id* at §§ 2.2, 2.8. Article 9 of the U.C.C. repealed the chattel mortgage statutes. *See* U.C.C. §§ 10-102, 10-103 (1977). The language of Section 261 of the Patent Act is derived from Act of 1870, ch. 230, § 36, which contains similar language. The requirement of recording patent assignments within three months to defeat subsequent purchasers is traceable back to the Patent Act of 1836.

⁵⁰ 35 U.S.C. § 261 (1988).

⁵¹ *See* 37 C.F.R. § 1.331 (1987).

⁵² *See generally* Weinberg & Woodward, *supra* note 8.

⁵³ *See supra* note 45.

⁵⁴ *See* Thomas Hemmendinger, *Perfecting Security Interests in Intellectual Property*, 35 R.I.B.J. at 8 (Nov. 1986).

⁵⁵ *See supra* note 45. Assignees should receive substantially all of the powers, duties, and privileges possessed by the grantor.

⁵⁶ *See* Thomas L. Bahrick, *Security Interests in Intellectual Property*, 15 AIPLA Q.J. 30 (1987).

⁵⁷ *See* U.C.C. § 9-401 (1977).

⁵⁸ *See* U.C.C. § 9-104 (1977).

⁵⁹ Official Comment 1, § 9-104.

⁶⁰ § 9-302 in relevant subsections provides that:

(3) The filing of a financing statement otherwise required by this Article is not necessary or effective to perfect a security interest in property subject to

(a) a statute of 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 Article for filing of the security interest . . .

(4) Compliance with a statute or treaty described in subsection (3) is equivalent to the filing of a financing statement under this Article, and a security interest in property subject to the statute or treaty can be perfected only by compliance therewith . . .

⁶¹ Official Comment 8, U.C.C. § 9-302 (1993).

⁶² *See* Bramson, *supra* note 2.

63 *See supra* note 10.

64 *See generally* Klumb, 57 Geo. Wash. L. Rev. 135 (1988). According to Klumb, dual filing places an unnecessary burden on the creditor and deflates the value of the property as collateral. *Id.* at 163. But, in reality, the burden is small compared to the added security.

65 *Id.* at 163-64.

66 *Id.* at 164.

67 *Id.*

68 *Id.*

69 *Id.*

70 *Id.*

71 *See* 35 U.S.C. § 261 (1993).

72 *See* U.C.C. §§ 9-102, 9-202 (1993).

73 A creditor/assignee may be involved in an infringement suit in two ways. First, the patent that has been assigned to him may be copied by a third party. The assignee brings an action against this party for damages. Second, unbeknownst to him, his patented product could infringe on a patent already issued to a third party. In that case, he will be subject to action against him.

74 This type of actions may arise when a patent application, not the patent itself, is assigned to the creditor. As the application makes its way through the PTO, there might be other patent applications that have similar claims, necessitating a determination of who is senior in the invention process. The party who is last to invent will not be issued a patent.

75 As will be seen later, the three-month grace period allowed under the Patent Act will create a host of priority problems for assignments.

76 13 U.C.C. Rep. Serv. (Callaghan) 336 (D.D.C. 1973).

77 There is no reason to suppose that § 261 prohibits it. In fact, one can make an argument that the statutory language requires the three-month grace period for conditional assignments. Klumb is totally silent about the effect of this peculiar feature.

78 *See* Weinberg & Woodward, *supra* note 8.

79 *See* Bramson, *supra* note 2.

80 *See* Weinberg & Woodward, *supra* note 8, at 86-87.

81 When movable goods are involved, Article Nine provides for a four-month relation back period under certain conditions. *See also* §§ 9-103, 9-301, 9-304.

82 *See Weinberg & Woodward, supra* note 8.

83 *Id.*

84 *See Bramson, supra* note 2.

85 *See Weinberg & Woodward, supra* note 8.

86 *See* 143 B.R. 360 (D. Md. 1992).

87 *Chesapeake Fiber*, 143 B.R. at 368.

88 *See Weinberg & Woodward, supra* note 8.

89 U.C.C. §§ 9-102, 9-202.

90 35 U.S.C. § 261 (1988).

91 *Id. See also supra* note 83.

92 *See Weinberg & Woodward, supra* note 8.

93 *Id.*

94 While Article Nine is far more complete for purposes of financing than the Patent Act, it is also somewhat incomplete for intellectual property financing. There is little in Official Comments to suggest that the Drafters gave much thought to using such property as collateral for loans.

95 *See* U.C.C. §§ 9-102, 9-202 (1993).

96 Typically, these lenders acquire security interests in patents via boiler-plate language “all general intangibles.”

97 It is useful to conceptualize a security agreement as creating a “right” in the lender pursuant to which he has a specific relief if the debtor’s obligation is not met. It is thus essentially a contract with a “liquidated damages” clause. Irrespective of title, the debtor still possesses the “right” to collateralize his burdened property. In contrast, a conditional assignment does something that is conceptually quite different. *See* Waterman v. McKenzie, 138 U.S. 252, 257-58 (1891).