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Note

**Recording Security Interests In Patents: Accepting A Traditional Federal
System To Preserve the Policies Of Patent Law**

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Recording Security Interests In Patents: Accepting A Traditional Federal System To Preserve the Policies Of Patent Law[†]

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I. INTRODUCTION

Corporations are increasingly using patents to augment their assets and increase their wealth. The modern economic use of patents has expanded beyond the traditional role of raising revenue from products and services in a monopolistic environment. The value of corporate patents is now significantly based on the strength of the right to exclude others from using such patents. The ability to enforce patent rights has created a “new” commodity for the corporate treasure chest. One result of this new-found popularity is the emergence of patents in the world of secured transactions. Using patents to secure credit, however, has created the risk of molding the rights of patentees and creditors in a manner that disregards the underlying policies of patent law. [1]

The current process by which a creditor seeks to perfect a security interest in a patent is a model of inefficiency. Both the Patent Act and Article 9 of the Uniform Commercial Code (“Article 9”) require a lender to provide constructive or actual notice in order to enforce a security interest against subsequent purchasers of a patent. A creditor seeking to record a security interest in a patent has a choice of two uncertain paths. The creditor can file a financing statement, covering an Article 9 security interest, with the Secretary of State¹ in the jurisdiction where the debtor is

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¹ A local filing in the debtor’s county may also be required by the “place of filing” provision adopted by the particular state version of the U.C.C. U.C.C. § 9-401.

located.² However, if a lender fails to record with the Patent and Trademark Office (“PTO”), and only files in accordance with Article 9, the lender may be preempted by a subsequent purchaser claiming bona fide purchaser status.³ [2]

In the alternative, the creditor can record the “interest” with the PTO, which suggests the safest method for a creditor to record a security interest in a patent. However, the effect of recording a security interest with the PTO is unclear.⁴ Section 261 of the Patent Act⁵ provides for the recording of assignments and mortgages, but is silent on security interests. While the patent regulations allow the recording of a security interest in a patent,⁶ it is unclear whether such recording provides actual or constructive notice to third parties.⁷ The mere recording of a security interest with the PTO may not necessarily perfect a creditor’s interest in a priority dispute against a senior creditor who has perfected under Article 9.⁸ Currently, the surest method of perfecting a security interest in a patent is to record both an assignment of legal title pursuant to section 261, and file as to the security interest under Article 9.⁹ [3]

² U.C.C. § 9-103(3)(d).

³ “[A]n 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 [PTO] within three months from its date or prior to the date of such subsequent purchase or mortgage.” 35 U.S.C. § 261 (1994).

⁴ Secured interests are also commonly filed pursuant to Article 9, in case the assignment is deemed to really be a security interest. See *infra* note 9 and accompanying text.

⁵ 35 U.S.C. § 261.

⁶ 37 C.F.R. § 3.11 (1995). The formal requirements under section 3.31 for the coversheet description of the recordable document include a description of the interest conveyed, such as “assignments, license, . . . [and] security interests”. Changes in Patent & Trademark Assignment Practice, 57 FED. REG. 29,634 (1992).

⁷ See Harold Weinberg & William Woodward, *Easing Transfer and Security Interest Transactions in Intellectual Property: An Agenda for Reform*, 79 KY. L.J. 61, 63 n.3 (1991). “While it may be possible to obtain and perfect a security interest in a patent without title in the patent being assigned to the creditor, it would seem unwise to attempt to do so.” Robert S. Bramson, *Intellectual Property as Collateral-Patents, Trade Secrets, Trademarks, and Copyrights*, 36 BUS. LAW 1567, 1583 (1981).

⁸ “The extent to which the recording provisions of section 261 pre-empt the U.C.C.’s perfection and priority rules governing the grant of security interests in patents is subject to considerable uncertainty.” See John L. Mesrobian & Kenneth R. Schaefer, *Security Interests in Intellectual Property*, 125 N.J. L.J. 336, Feb. 15, 1990, at 337.

⁹ The danger exists that an assignment may be viewed as a disguised security interest. The established practice is to assign and record legal title to the creditor, and then to file a security interest pursuant to Article 9. See Raymond T. Nimmer & Patricia A. Krauthaus, *Secured Financing And Information Property Rights*, 2 HIGH TECH. L.J. 195, 208 (1987). The purpose of the Article 9 filing is to ensure perfection in case the assignment is held to be a security interest in disguise. *Id.* Case law,

The extent of federal preemption over Article 9 is uncertain.¹⁰ Under current law, if a dispute develops between a secured creditor who has filed pursuant to Article 9, but who has not recorded with the PTO, and a subsequent secured creditor who has only recorded with the PTO, three reasonable positions may be entertained. First, the Article 9 secured creditor will likely argue that Article 9 is controlling because section 261 deals with assignments of legal title and not security interests.¹¹ Thus, the Article 9 creditor will argue that a federal recording is unnecessary for a security interest transfer, since legal title is not vested. Second, the PTO creditor may argue that Article 9 is completely preempted because all transfers affecting patents must be recorded with the PTO.¹² Third, a partial preemption position may be argued by the PTO creditor, where the Article 9 filing is only effective against lien creditors.¹³ [4]

Commentary on the extent of federal preemption over Article 9 has been relatively scarce. Scholars who have grappled with the issue have, for the most part, argued in favor of preempting Article 9 with respect to intellectual property.¹⁴ In their analysis, those commentators have used various means to resolve the issue, including the Official Comments to the Uniform Commercial Code,¹⁵ the Ship

however, states that a transfer of an interest in a patent is *either* an assignment or a license. See *Waterman v. MacKenzie*, 138 U.S. 252, 255 (1891). However, if the debtor retains any interest in the patent, he has created a license and not an assignment. *Id.* To ensure a proper collateral assignment, under traditional methods, the debtor should transfer to the creditor all the rights in the patent for real value with a grant back clause, stating that the assignment is void on performance of payment. *Id.* The creditor may then grant an exclusive license to the debtor, but must be careful not to grant back *all* of the rights, which would result in an assignment, as opposed to a license. See *CMS Industries, Inc. v. L.P.S. Int'l, Ltd.*, 643 F.2d 289, 294 (5th Cir. 1981).

¹⁰ The fact that Article 9 financing may be preempted for intellectual property is relatively unknown by creditors. See Henry Beck, *The Development, Financing, & Acquisition of Information Age Assets*, THE COMPUTER LAW., Jan., 1995, at 14.

¹¹ *Holt v. U.S.*, 13 U.C.C. Rep. Serv. 336, 338 (D.D.C. 1973) (holding that section 261 does not apply to security interests, but to assignments).

¹² See *City Bank & Trust Co. v. Otto Fabric, Inc. (In re Otto Fabric, Inc.)*, 55 B.R. 654 (Bankr. D. Kan. 1985), *rev'd*, 83 B.R. 780 (D. Kan. 1988) (holding that section 261 preempts Article 9 completely).

¹³ See discussion *infra* notes 70-130 and accompanying text; see e.g., *In re Transportation Design & Technology*, 48 B.R. 635 (S.D. Cal. 1985).

¹⁴ Shreen Danamraj, *Priority Disputes Involving Security Interests in Patents: Case Law and Current Proposals*, 2 TEX. INTELL. PROP. L.J. 257, 258 (1994).

¹⁵ See Bramson, *supra* note 7.

Mortgage Act of 1920,¹⁶ and proposals for revisions to the Patent Act to account for security interests.¹⁷ [5]

In contrast, this Note addresses the conflict between the two governing laws by emphasizing the need to preserve patent policy. Only in an exclusive federal system can the interests of creditors be adequately served while preserving patent policies. As a result, the means to have an effective system for perfecting a creditor's interest in a patent now exists for judicial preemption of Article 9. [6]

This Note will attempt to rationalize the ambiguous and seemingly contradictory law on this subject. Specifically, Part II of this Note will set forth applicable provisions under the Patent Act and Article 9. This Part will then detail how case law has dealt with the preemption problem. Part III will analyze the type of creditor interests that are involved in the federal recording system. As both courts and scholars have questioned the impact of recording Article 9 type security interests in the federal system, Part III will put forth reasons why security interests do not fall under the proper interpretation of section 261 of the Patent Act. Rather, this Part will argue that security interests can effectively be recorded with the PTO in a manner that provides constructive notice to all third parties. Lastly, Part IV of this Note will discuss how underlying policies of both Article 9 and the Patent Act are impeded by their dual existence. As such, Part IV will argue that the exclusive use of the federal recording system best protects the underlying policies of both systems, with specific emphasis on protecting patent licensees in secured transactions. [7]

II. PROVISIONS AND CASE LAW ON THE RECORDING PROVISIONS OF THE U.C.C. AND PATENT ACT

A. *Recording a Creditor's Interest Under Section 261 of the Patent Act*

Section 261 of the Patent Act states that "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 [PTO] within three months from its date or prior to the date of such subsequent purchase or mortgage."¹⁸ With respect to the recording of a creditor's interest, the ambiguity

¹⁶ See Marci Klumb, Note, *Perfection of Security Interests in Intellectual Property: Federal Statutes Preempt Article 9*, 57 GEO. WASH. L. REV. 135 (1988).

¹⁷ See Weinberg & Woodward, *supra* note 7.

¹⁸ 35 U.S.C. § 261.

arises from the statute's failure to expressly provide for security interests.¹⁹ Furthermore, courts have not interpreted "assignment" under section 261 to include security interests.²⁰ However, security interests may be recorded under the regulations of the PTO, which state that "[o]ther documents . . . affecting title to applications, patents . . . will be recorded as provided . . . [with the PTO] . . . at the discretion of the Commissioner."²¹ Documents that are not assignments and affect title to patents are generally understood to include security interests.²² [8]

A creditor can record either a security interest or an assignment with the PTO.²³ However, the effect of recording a security interest with the PTO is unclear, since such recording may or may not provide constructive notice to third parties.²⁴ As a result, creditors must record "collateral assignments"²⁵ pursuant to section 261 in order to ensure protection against subsequent creditors and assignees.²⁶ In addition, creditors perfect in accordance with Article 9 to protect against the possibility that the assignment will be deemed a security interest by a court.²⁷ [9]

¹⁹ Under the U.C.C., a security interest is defined as "an interest in personal property or fixtures which secures payment or performance of an obligation." U.C.C. § 1-201 (37).

²⁰ See *Holt*, 13 U.C.C. Rep. Serv. at 338 (holding that the Patent Act's recording statute did not apply to security interests because security interests did not convey legal title); *City Bank & Trust Co.*, 83 B.R. at 782-83 (distinguishing the grant of a security interest from an assignment). "The Patent Act's comprehensive regulation scheme governing ownership rights in a patent does not, however, necessarily conflict with an exercise of state rights over the questions of perfection and priority of security interests in the patent." *In re Transportation Design*, 48 B.R. at 638. "The uncertainty [of federal preemption over state regulated security interests] centers around whether the reference to 'assignment' and 'grants' includes security interests or refers only to conveyances that transfer title to the creditor." Nimmer & Krauthaus, *supra* note 9, at 207.

²¹ 37 C.F.R. § 3.11.

²² See *Changes in PTO Practice*, *supra* note 6.

²³ See 37 C.F.R. § 3.11 (permitting the recording of documents affecting title to patents and patent applications); *Changes in PTO Practice*, *supra* note 6.

²⁴ See, e.g., *Holt*, 13 U.C.C. Rep. Serv. at 338-39; see also *Bramson*, *supra* note 7, at 1584; *Weinberg & Woodward*, *supra* note 7, at 63 n.3.

²⁵ Collateral assignments vest legal title with the creditor. See discussion *infra* note 35 and accompanying text.

²⁶ See *Mesrobian & Schaefer*, *supra* note 8, at 337.

²⁷ See *id.*

In either the case of a security interest or a collateral assignment, the interest cannot be recorded until the patent application is filed.²⁸ The PTO records documents affecting title to a patent according to the patent (or patent application) number. If the creditor records a security interest, the creditor must comply with the formal requirements of the patent regulations, including specification to the patent or patent application number.²⁹ Furthermore, a federal recording must contain reference to an interest in an existing patent or patent application,³⁰ rather than give notification of an expectant or uncompleted transaction under Article 9.³¹ In addition, the security agreement must specify the interest allocated to the creditor, because the PTO treats assignments and security interests differently.³² For instance, with a collateral assignment, the creditor, as a holder of legal title, has the exclusive responsibility for prosecuting the patent.³³ [10]

Section 261 prioritizes assignments in patents according to the first to acquire rights rule, while providing protection for subsequent purchasers for value and without notice of the prior assignment.³⁴ Effectively, this forces assignees to record their interests pursuant to section 261, in order to provide constructive notice to subsequent purchasers. However, as an exception to the subsequent bona fide purchaser rule, the prior assignee has the benefit of a three-month “look back” period.³⁵ The three-month period allows the assignee to receive priority over all subsequent assignments, provided that the assignee records within three months

28 37 C.F.R. § 3.21.

29 “An assignment relating to a patent must identify the patent by the patent number.” 37 C.F.R. §§ 3.21, 3.27. Documents submitted to the PTO for recording must be accompanied by a coversheet referring to the specific patents. A coversheet must include the name of the party conveying the interest, the name and address of the party receiving the interest, a description of the interest conveyed, the patent or application number, and the date the document was executed. 37 C.F.R. § 3.31.

30 “Section 261 requires that the transaction document be filed and contemplates individual and discrete filings as additional patent assignments are made.” Weinberg & Woodward, *supra* note 7, at 75.

31 Article 9 permits the filing of financing statements, which puts third parties on notice of the existence of the security interest. The notice filing also extends to after acquired property. See discussion *infra* notes 45-56 and accompanying text.

32 Security interests were commonly filed as “conditional assignments” under 37 C.F.R. § 3.56. The PTO has since clarified section 3.56, so that security interests are not treated as conditional assignments. Rather, the PTO views security interests and assignments as separate forms of interest. See *infra* note 108; Changes in PTO Practice, *supra* note 6.

33 See 37 C.F.R. § 3.71.

34 35 U.S.C. § 261.

35 35 U.S.C. § 261.

from the date of the assignment's execution. As a result, a subsequent assignee for value and without notice of the prior assignment loses priority to the senior assignee who records within three months of her prior assignment.³⁶ Furthermore, an assignee is not barred from recording an assignment after three months, and will have priority so long as a subsequent bona fide purchaser has not acquired the patent.³⁷ [11]

B. *Filing a Security Interest in a Patent Under Article 9*

Article 9 provides for the creation of consensual security interests in a debtor's personal property or fixtures. The security interest protects the creditor's interest by securing the debtor's obligation with collateral.³⁸ Article 9 utilizes security interests, instead of collateral assignments, in order to facilitate secured transactions by avoiding the need to transfer legal title in the collateral.³⁹ Furthermore, under Article 9, patents are characterized as "general intangibles."⁴⁰ [12]

The creditor who wishes to obtain a security interest enforceable against the debtor must have the interest "attach." Attachment requires a written agreement signed by the debtor that grants the creditor the security interest.⁴¹ The security agreement must contain "a description of the collateral."⁴² Adequacy of the

³⁶ 35 U.S.C. § 261. See Weinberg & Woodward, *supra* note 7.

³⁷ See Weinberg & Woodward, *supra* note 7, at 75.

³⁸ U.C.C. § 1-201(37).

³⁹ Article 9 utilizes a functional approach to promoting collateral value, in contrast to a "title theory" secured transaction system. See *City Bank & Trust Co.*, 83 B.R. at 783. Article 9 security interests also differ significantly from the traditional "chattel mortgage" system, in order to ease secured transactions. Weinberg & Woodward, *Easing Transfer*, *supra* note 7, at 65-66. See also U.C.C. § 9-101, Official Comment, and U.C.C. § 9-202.

⁴⁰ U.C.C. § 9-106 states that "[g]eneral intangibles' means any personal property (including things in action) other than goods, accounts, chattel paper, documents, instruments, and money." This would include copyrights, trademarks, and patents "except to the extent that they may be excluded by § 9-104(a)." U.C.C. § 9-106, Official Comment to 1990 Official Text.

⁴¹ "[A] security interest is not enforceable against the debtor or third parties with respect to the collateral and does not attach unless . . . the debtor has signed a security agreement which contains a description of the collateral . . ." U.C.C. § 9-203 (1). Furthermore, attachment requires that the debtor have rights in the collateral at the time she grants a security interest, and that the creditor give value for the security interest. *Id.*

⁴² U.C.C. § 9-203(1)(a).

description in the financing statement is often a matter of litigation in the courts.⁴³ A security agreement may also include “after-acquired property,” removing the need for creating a new security agreement when collateral is later acquired by the debtor.⁴⁴ [13]

Once the security interest has attached, the creditor must ensure that the interest is enforceable against third parties and subsequent purchasers. The concepts of perfection and priority relate to enforcement of security interests. The creditor needs to perfect and preserve priority in his security interest against subsequent creditors and transferees. Perfection protects the creditor from secured creditors who claim the same collateral,⁴⁵ as well from lien creditors⁴⁶ such as trustees in bankruptcy.⁴⁷ The perfection of a security interest in “general intangibles” occurs at the latter time of (1) the attachment of the security interest under a security agreement; and (2) the filing of a corresponding financing statement.⁴⁸ For most collateral, including “general intangibles,” filing is required. Under Article 9, priority is generally preserved according to the first-to-file rule,⁴⁹ which allows the creditor to preserve priority from the date a complying financing statement is filed.⁵⁰ The financing statement may be filed before the security interest attaches.⁵¹ In addition, the financing statement can be broad,⁵² and may also include “after

⁴³ See *Safe Deposit Bank & Trust Co. v. Berman*, 393 F.2d 401, 403 (1st Cir. 1968) (holding that Massachusetts law is sympathetic to “the extent to which the intention of the parties and equitable considerations may affect rights ineffectively preserved in legal instruments”).

⁴⁴ U.C.C. § 9-204.

⁴⁵ U.C.C. § 9-301. With respect to general intangibles and accounts, perfection also protects the creditor against purchasers of value and without knowledge of the security interest.

⁴⁶ U.C.C. § 9-301(1).

⁴⁷ U.C.C. § 9-301(3).

⁴⁸ U.C.C. § 9-303(1); *see also* U.C.C. § 9-302(1).

⁴⁹ With the exception of purchase money security interests, conflicting security interests rank according to priority in time of filing or perfection. U.C.C. § 9-312(5)(a).

⁵⁰ U.C.C. § 9-312(5)(a).

⁵¹ U.C.C. § 9-402(1).

⁵² A financing statement indicates “merely that the secured party who has filed may have a security interest in the collateral as described.” U.C.C. 9-402(1) cmt. 2. Some courts have extended the breadth of financing statements to allow perfection for financing statements that include everything the debtor has or may acquire. *See, e.g., In re JCM Cooperative, Inc.*, 8 U.C.C. Rep. Serv. 247, at 251 (Bankr. Mich. 1970) (holding that a perfected security interest existed in account receivables when the creditor’s financing statement that included the words “all of the debtor’s personal property now owned or hereafter acquired”).

acquired property.”⁵³ As a result, the creditor may have an effective priority date before either the security interest attaches or collateral is acquired by the debtor. [14]

The mechanics of Article 9 financing differ significantly from the federal recording system provided by section 261. Under Article 9, a debtor must file a financing statement in the debtor’s location.⁵⁴ Furthermore, the U.C.C. recordings are filed and indexed according to the debtor’s name.⁵⁵ Lastly, the U.C.C. does not in general provide for a ‘look back’ period with respect to the perfection of security interests.⁵⁶ [15]

C. *Applicable Law on Federal Preemption of Article 9*

The recording section of the Patent Act makes no reference to security interests.⁵⁷ If federal patent policy is ignored, the bare language of section 261 can be interpreted to exclude security interests, and thus leave room for Article 9 recordings of security interests.⁵⁸ [16]

Federal preemption of recording security interests in patents is contemplated by two sections of Article 9.⁵⁹ However, neither section sheds light on whether

⁵³ “[A] financing statement is effective to encompass a security agreement not in existence and not contemplated at the time the notice was filed, if the description of collateral in the financing statement is broad enough to encompass them. Similarly, the financing statement is valid to cover after acquired property and future advances under security agreements whether or not mentioned in the financing statement.” U.C.C. § 9-402 cmt. 2.

⁵⁴ The proper jurisdiction for “general intangibles” is the debtor’s location. U.C.C. § 9-103(3)(b). Depending upon the jurisdiction, additional filings may be required in county offices. U.C.C. § 9-401 (Alternative Subsections).

⁵⁵ “Having the correct name of the debtor on the financing statement is crucial to the Code’s notice filing system because financing statements are indexed under the debtor’s name.” See ROBERT L. JORDAN & WILLIAM D. WARREN, *COMMERCIAL LAW* 32 (1992).

⁵⁶ The U.C.C. does provides automatic perfection for “purchase money security interests” in collateral other than inventory, which provides the debtor with a 10-day grace period to perfect his interest. U.C.C. § 9-312(4).

⁵⁷ 35 U.S.C. § 261.

⁵⁸ See *Holt*, 13 U.C.C. Rep. Serv. at 339.

⁵⁹ First, “[w]here a federal statute regulates the incidents of security interest in particular types of property, those security interest are of course governed by the federal statute and excluded from this Article.” U.C.C. § 9-104 cmt. 1. The Comment continues by stating that “[a]lthough the Federal Copyright Act contains provisions permitting the mortgage of a copyright and for the recording of an

section 261 preempts Article 9.⁶⁰ Since the U.C.C. is individually adopted by states, and interpreted differently according to each jurisdiction, the uncertain code comments carry little weight in helping determine the extent of federal preemption of Article 9 with respect to patents.⁶¹ [17]

Cases addressing the issue of federal preemption of Article 9 with respect to patents are scarce. No appellate court has issued a holding that states the extent of federal preemption of the U.C.C. provisions with respect to patents.⁶² The present case law is divided as to whether an Article 9 filing can preserve a creditor's priority, or perfect the interest against subsequent purchasers or lien creditors. [18]

In *Holt v. United States*,⁶³ the creditor had been granted a security interest in the debtor's patent application and had perfected the security interest pursuant to Article 9. Subsequently, a tax lien was issued and the debtor's applications were sold at a tax sale.⁶⁴ The creditor claimed his interest in the patent application was perfected, and not subject to the tax lien.⁶⁵ The court held that Article 9 was not

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 [Article 9]." *Id.* The Comment invites a comparison with the recording provisions of the Patent Act. The validity of this Comment should be called into question, because this Comment referred to the 1909 Copyright Act. Section 205 of the 1976 Copyright Act, with the 1988 Berne Amendment, provides for constructive notice of all documents filed with the office, as long as the work is specifically identified. *See* 17 U.S.C. § 205(1) (1988). Second, "[t]he filing of a financing statement otherwise required by [Article 9] is not necessary or effective to perfect a security interest in property subject to (a) a statute or treaty of the United States which provides for a national or international registration or which specifies a place of filing different from that specified in the Article for filing of the security interest." U.C.C. § 9-302(3)(a). *See also* U.C.C. § 9-302(4).

⁶⁰ *See* Bramson, *supra* note 7, at 1578 (stating that the U.C.C. comments with respect to preemption are "unclear and inconsistent"); Damamraj, *supra* note 14, at 257; *but see* Klumb, *supra* note 15, at 139 (using comments to analyze U.C.C. §§ 9-104(a), 9-302, "which serve as the foundation for determining the extent to which the federal law governing intellectual property preempts Article 9."). Consider the proposed ALI revision, which begs the question by stating that "a security interest subject to any statute or treaty of the United States, to the extent that the statute or treaty preempts this article . . ." U.C.C. § 9-104(1) (Proposed Official Draft 1995).

⁶¹ Consider Comment 1 to U.C.C. section 9-104, which is outdated in its reference to the recording provisions of the 1909 Copyright Act, and which is in direct conflict with case law decisions. *See In re Peregrine Entertainment*, 116 B.R. 194, 202-03 (C.D. Cal. 1990) (holding that the 1976 Copyright Act preempts Article 9, and criticising patent cases that hold that an Article 9 filing system can coexist with a federal recording statute).

⁶² *See* Mesrobian & Schaefer, *supra* note 8, at 337.

⁶³ 13 U.C.C. Rep. Serv. at 337.

⁶⁴ *Id.*

⁶⁵ *Id.*

preempted by the Patent Act's recording provision, because Article 9 dealt with security interests rather than assignments.⁶⁶ The court concluded that a security interest could be granted in a patent application.⁶⁷ Since the debtor did not convey title to the patent, the court held that the Patent Act's assignment statute was inapplicable.⁶⁸ However, the court did not have to address the specific issue of a subsequent purchaser/creditor who accepts an assignment in the patent in reliance on the federal records.⁶⁹ [19]

In *In re Transportation Design*,⁷⁰ the bankruptcy court held that section 261 "partially" preempted Article 9. The court concluded that Article 9 only protected a creditor from subsequent lien holders.⁷¹ The creditor had filed a financing statement with an "after-acquired property" clause.⁷² The security interest in the after-acquired property had been granted prior to the issuance of the patent.⁷³ The patent issued while the debtor was bankrupt.⁷⁴ The creditor and trustee of the debtor each claimed rights to the patent.⁷⁵ The trustee argued that Article 9 was preempted by section 261. As a result, the trustee argued that the creditor's failure to file a collateral assignment pursuant to section 261 resulted in an unperfected security interest.⁷⁶ [20]

⁶⁶ *Id.* at 339. As a result of the 1994 Amendments to the Patent Act, Pub. L. 103-465, the recording section of the Patent Act changed from 35 U.S.C § 361 to 35 U.S.C. § 261.

⁶⁷ *Id.* at 339.

⁶⁸ *Id.*

⁶⁹ *Id.*

⁷⁰ 48 B.R. at 635.

⁷¹ *Id.* at 637.

⁷² A filing with respect to an after acquired property clause gives the creditor priority in the debtor's property acquired after the date of the initial filing. A security agreement granting the interest in the after acquired property is necessary to create the creditor's interest. *See supra* notes 38-56 and accompanying text.

⁷³ 48 B.R. at 637.

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ *Id.*

In reasoning that a security interest did not grant the creditor a present ownership interest, the court characterized the security interest as a lesser right than a mortgage or an assignment.⁷⁷ According to the court, section 261 governed transfers of present ownership, which were assignments and mortgages.⁷⁸ As a result, the court concluded that section 261 did not require security interests and licenses to be filed with the PTO.⁷⁹ The court determined that the filing of a security interest could serve only two purposes: (1) to provide notice of the security interests in the collateral against subsequent or competing liens; and, (2) to provide the creditor with protection against the debtor transferring legal title to the collateral through mortgage or assignment.⁸⁰ The court held that an Article 9 filing serves only the first objective, which was to protect the security interest against subsequent lien holders and creditors.⁸¹ According to the court, if the legal title of the patent is transferred in a subsequent assignment or mortgage, then a federal filing pursuant to section 261 would be necessary.⁸² Since the debtor had not transferred legal title to the patent, the debtor's trustee in bankruptcy was held to be the holder of the patent.⁸³[21]

The court recognized that its holding left “a fairly narrow area remaining for state regulation.”⁸⁴ Under *In re Transportation Design*, an Article 9 perfected creditor did not defeat the interests of a subsequent assignee.⁸⁵ The court recognized that when an assignment is recorded pursuant to section 261, and in conflict with a senior creditor who has only perfected under Article 9, the federal statute will preempt Article 9.⁸⁶ The court did not address the issue of whether an assignee or mortgagee who failed to record pursuant to section 261 could claim priority over a creditor who had perfected under Article 9. [22]

77 *Id.* at 639 (citing *Waterman*, 138 U.S. at 252).

78 *Id.*

79 *Id.*

80 *Id.* at 639.

81 *Id.*

82 *Id.* at 640.

83 *Id.*

84 *Id.* at 639.

85 *Id.*

86 *Id.* at 639-40.

In *City Bank & Trust Co. v. Otto Fabric, Inc.*,⁸⁷ the district court addressed the issue of how a secured creditor can perfect a security interest against a lien creditor.⁸⁸ The debtor had executed a security agreement that made specific reference to three patents.⁸⁹ Seven days later, the creditor filed an Article 9 financing statement.⁹⁰ On the same day the financing statement was filed, a collateral assignment of the patents was executed by the debtor to the creditor.⁹¹ Eight days later, the collateral assignment was recorded in accordance with section 261.⁹² The debtor filed for bankruptcy a short time later, so that the ninety-day preference period⁹³ included the date of the federal filing, but not the Article 9 filing.⁹⁴ The trustee in bankruptcy claimed that the Article 9 perfection of the security interests in the three patents was preempted by section 261.⁹⁵ Accordingly, the date of perfection for the security interest in the patents was really the date the collateral assignment was recorded by the creditor pursuant to section 261.⁹⁶ [23]

Prior to the appeal to the district court, the bankruptcy court had held that section 261 controlled the method of perfecting a security interest in patents, and thus fully preempted Article 9.⁹⁷ The court rejected the partial preemption position of *In re Transportation Design*⁹⁸ in stating that an Article 9 filing served no purpose with respect to patents.⁹⁹ According to the bankruptcy court, “[o]ne of the purposes

87 83 B.R. at 780.

88 *Id.*

89 *Id.*

90 *Id.*

91 *Id.*

92 *Id.*

93 An unperfected security interest is subject to the claims of the trustee in bankruptcy. 11 U.S.C. § 547(e)(2)(A) (1995). Without perfection, the secured creditor must have his collateral divided equally with the shares of the other creditors in bankruptcy. *Id.*; see also U.C.C. § 9-301(1)(b), (4).

94 *City Bank & Trust Co.*, 83 B.R. at 781.

95 *Id.*

96 *Id.*

97 *In re Otto Fabric, Inc.* 55 B.R. at 658.

98 48 B.R. at 640.

99 *In re Otto Fabric, Inc.*, 55 B.R. at 654.

of [A]rticle 9 is to provide rational and convenient filing systems for security interests. Requiring both federal and U.C.C. filing to perfect a creditor's interest in a patent would be contrary to that purpose."¹⁰⁰ [24]

Besides recognizing the inefficiency of the resulting dual recording systems, the bankruptcy court recognized fundamental principles of patent law.¹⁰¹ The bankruptcy court cited case law which held that a patent interest was either an assignment or a license.¹⁰² Accordingly, the bankruptcy court reiterated the rule of *Waterman v. MacKenzie*,¹⁰³ which stated that a patent must be assigned in the form of a mortgage transferring legal title in order to be collateral.¹⁰⁴ The bankruptcy court concluded that a federal filing protected the assignee's interest against all third parties.¹⁰⁵ As a result, the federal recording statute was an adequate alternative recording statute.¹⁰⁶ [25]

The district court rejected the full preemption holding of the bankruptcy court, and reiterated the partial preemption holding of *In re Transportation Design*.¹⁰⁷ The court based its decision in part on a mistaken assumption that the recording of a security interest with the PTO was equivalent to an assignment.¹⁰⁸

100 *Id.*

101 *Id.*

102 "[A]n agreement transferring patent rights must either be an assignment or a license." *Id.* (citing *Waterman*, 138 U.S. at 255); see also *CMS Indus., Inc.*, 643 F.2d at 289; *United States v. Dubilier Condenser Corp.*, 289 U.S. 178, 187 (1933).

103 138 U.S. at 258.

104 *In re Otto Fabric, Inc.*, 55 B.R. at 657.

105 *Id.*

106 *Id.* at 658.

107 *Id.*

108 The court stated that patent assignments that were conditional on the performance of certain conditions, such as a monetary payment or other subsequent conditions, if recorded with the Patent and Trademark Office, are regarded as absolute assignments. *City Bank & Trust Co.*, 83 B.R. at 782 (citing 37 C.F.R. § 1.333 (1987)). Security interests are now excluded by 37 C.F.R. § 3.56 (1995). The PTO states that

[s]ection 3.56 is applicable only to assignments, as they are defined by § 3.1, that is, a transfer of right, title and interest in a patent or a trademark. A security interest or a security agreement is in the nature of a lien, not an assignment. Accordingly, § 3.56 would not apply to security interests or security agreements which are also recordable. It applies to conditional assignments because the office has no way of determining whether and when the conditions are satisfied and therefore must address this type of assignment in a uniform manner.

The court concluded that “the federal statute does not expressly state that one must file an assignment with the [PTO] to perfect a security interest.”¹⁰⁹ Second, the court stated that section 261 did not require the federal filing of an assignment to protect against a lien creditor.¹¹⁰ As a result, the court held that a state filing could perfect a creditor’s interest against a subsequent lien creditor or trustee.¹¹¹ Third, the court correctly noted that the conceptual basis of a collateral assignment was inconsistent with the notion of a security interest.¹¹² The court concluded that a federal filing is not required to perfect a security interest against a lien creditor or trustee in bankruptcy. [26]

The court in *Chesapeake Fiber Packaging Corp. v. Sebro Packaging Corp.*¹¹³ similarly held that section 261 partially preempted Article 9.¹¹⁴ In *Chesapeake*, the debtor had granted a security interest in a patent application to a creditor, who subsequently perfected pursuant to Article 9.¹¹⁵ The debtor went bankrupt two years later, neglecting to pay legal bills for the prosecution of the patent.¹¹⁶ The defendant, who had no knowledge of the creditor’s interest, agreed to pay the legal fee for the prosecution if the patent was issued.¹¹⁷ Prior to the issuance of the patent, the creditor seized the debtor’s property, including the interest in the patent.¹¹⁸ The plaintiff purchased the rights to the patent application from the creditor.¹¹⁹ The defendant claimed that the creditor had not properly perfected the

Changes in PTO Practice, *supra* note 6.

109 *City Bank & Trust Co.*, 83 B.R. at 782.

110 *Id.*

111 *Id.*

112 *Id.* The court’s statement is correct in that the creation of the security interest is an important factor in determining whether there is federal preemption. However, recording a security interest with the PTO is not delivery of legal title to the creditor; that is, a security interest cannot be transformed into a collateral assignment by a section 261 recording. *See* Changes in PTO Practice, *supra* note 6.

113 143 B.R. 360, 369 (D. Md. 1992), *aff’d*, 8 F.3d 817 (4th Cir. 1993).

114 *Id.* at 365.

115 *Id.* at 364.

116 *Id.* at 365.

117 *Id.* at 368.

118 *Id.*

119 *Id.*

security interest in the patent because no federal recording was made.¹²⁰ As a result, the defendant claimed ownership of the patent by virtue of paying the legal fees for the patent's prosecution. The defendant reasoned that payment of the patent application's legal fees made the defendant "a subsequent purchaser of the patent application, for valuable consideration without notice," pursuant to section 261.¹²¹ [27]

The *Chesapeake* court held that the creditor, as the plaintiff's assignor, had legitimately perfected the security interest against the trustee in bankruptcy.¹²² Therefore, the court reasoned that the creditor had properly seized the property rights in the patent application when the debtor had gone bankrupt.¹²³ The court followed *In re Transportation Design*¹²⁴ in stating that a subsequent purchaser, without notice of the creditor's claim and for value,¹²⁵ can defeat the creditor's perfected interest under Article 9.¹²⁶ However, the court stated that the defendant had failed to procure title to the patent application.¹²⁷ The payment of the legal fees was to induce the completion of the patent's prosecution, and not for an assignment of the application.¹²⁸ Thus, the court concluded that an Article 9 filing did perfect a security interest against a lien creditor, but could be defeated by a subsequent purchaser for value and without notice.¹²⁹ But in this case, the defendant had not paid value, even though payment of the legal fees had been made in reliance on the records of the PTO.¹³⁰ [28]

120 *Id.*

121 *Id.* at 369.

122 *Id.*

123 *Id.*

124 48 B.R. at 640.

125 143 B.R. at 369.

126 *Id.*

127 *Id.*

128 *Id.*

129 *Id.*

130 *Id.*

Cases involving copyrights as collateral have ruled that under the Copyright Act of 1976,¹³¹ a security interest recording must be perfected through a federal recording.¹³² The recording provision of the Copyright Act provides in part that “[a]ny transfer of ownership or other documents pertaining to a copyright may be recorded in the Copyright Office.”¹³³ Furthermore, all documents recorded pursuant to section 205 (a) provide constructive notice of “the facts stated in the recorded document.”¹³⁴ A comparison of the recording provisions of the Copyright Act shows that unlike the Patent Act, security interests in copyright works are recordable and such recordings *definitely* provide constructive notice of the interest.
[29]

The cases pertaining to recording of copyright interests help identify many of the principles necessary in determining the extent of federal preemption of Article 9. In the leading case, *In re Peregrine Entertainment*,¹³⁵ the court held that the creditor’s Article 9 filing did not perfect a security interest against a debtor in possession¹³⁶ in copyright works.¹³⁷ According to the court, predictability of ownership and uniformity are considerations that mandate fully preempting Article 9 with section 205 of the Copyright Act.¹³⁸ The court further reasoned that the predominant purpose of a federal statute is to provide a central recording office, and to the extent that there is a competing state system, the federal system is undermined.¹³⁹ Furthermore, the court reasoned that the conflicting provisions of Article 9, such as the absence of a look back period,¹⁴⁰ cannot be reconciled with the

131 17 U.S.C. §§ 101-810 (1992).

132 See, e.g., *In re AEG Acquisition Corp.*, 127 B.R. 34, 40 (Bankr. C.D. Cal. 1991), *aff’d*, 161 B.R. 50 (Bankr. 9th Cir. Cal. 1993) (holding that a security interest in film is perfected under the 1976 Copyright Act).

133 17 U.S.C. § 205(a).

134 *Id.* § 205(c).

135 116 B.R. at 204.

136 The debtor in possession enjoys the same status as a lien creditor and a trustee in bankruptcy. 11 U.S.C. § 544(a)(1) (1992).

137 *In re Peregrine Entertainment*, 116 B.R. at 204.

138 *Id.*

139 *Id.* at 200-01 (citing *Danning v. Pacific Propeller*, 620 F.2d 731, 735-56 (9th Cir. 1986)). *Danning* held that the predominant purpose of the Federal Aviation Act’s recording system was to provide one central place for the filing of lien interests in aircrafts. *Danning*, 620 F.2d at 889.

140 *In re AEG Acquisition Corp.*, 127 B.R. at 200.

federal system in a manner that provides uniformity or certainty. As such, the *In re Peregrine* court stated that a dual recording system fails to meet the goals of either the federal or state recording systems.¹⁴¹ Subsequent cases have followed *In re Peregrine* in holding that Article 9 is completely preempted with respect to the Copyright Act.¹⁴² [30]

III. RECORDING A SECURITY INTEREST UNDER THE FEDERAL SYSTEM

The federal system's ambiguous provisions regarding security interests hinders the understanding of preemption over Article 9. Specifically, the federal recording system is unclear with respect to (1) the type of security interest which section 261 governs;¹⁴³ and (2) the effects of recording a security interest not within the wording of section 261.¹⁴⁴ Modern inclination to reduce the formalities of security interests has produced this perceived ambiguity in the federal system.¹⁴⁵ In comparison, the federal recording system provided under section 261 has been essentially the same since 1870.¹⁴⁶ As a result, section 261 does not explicitly provide for the modern security interest created under Article 9. [31]

A. *The Scope Of Section 261*

¹⁴¹ *Id.* at 200-01.

¹⁴² *In re AEG Acquisition Corp.*, 127 B.R. at 40 (holding that a security interest in film is perfected under the Copyright Act).

¹⁴³ "The uncertainty [of Article 9 preemption] centers around whether the reference to 'assignments' and 'grants' includes security interests or refers only to conveyances that transfer legal title to the creditor." Nimmer & Krauthaus, *supra* note 9, at 207.

¹⁴⁴ See Weinberg & Woodward, *supra* note 7, at 67 n.3.

¹⁴⁵ See Weinberg & Woodward, *supra* note 7, at 65-70 (detailing Article 9 reform of security interests in intellectual property).

¹⁴⁶ The Patent Act of 1870, ch. 230, 16 Stat. 198-217 (1870) (codified as amended at 35 U.S.C. § 261) ("That every patent or any interest therein shall be assignable in law, by an instrument in writing; and the patentee or his assigns or legal representatives may, in like manner, grant and convey an exclusive right under his patent to the whole or any specified part of the United States, and said assignment, grant, or conveyance shall be void as against any subsequent purchaser or mortgagee for valuable consideration, without notice, unless it is recorded in the patent office within three months from the date thereof.").

The scope of section 261 is limited to transfers of legal title. The Supreme Court in *Waterman v. MacKenzie*¹⁴⁷ held that an assignment under the patent recording statute¹⁴⁸ transfers legal title to the assignee.¹⁴⁹ As such, *Waterman* held that mortgages transfer legal title to the creditor under the patent recording statute. In support of its analysis, *Waterman* recited common law to distinguish mortgages that secure real property from mortgages on personal property.¹⁵⁰ For real property, a mortgage separates legal title from equitable title.¹⁵¹ In *Waterman*, a mortgage securing real property was defined by state law to be either a lien or a transfer of legal title.¹⁵² As such, an assignor could transfer bare legal title in real property to the creditor, while retaining the equitable title in the property.¹⁵³ In contrast, a personal property mortgage transferred both equitable and legal title to the creditor.¹⁵⁴ [32]

Based on the traditional understanding of mortgages for personal property, the *Waterman* court held that a recording statute for personal property is an equivalent substitution for possession.¹⁵⁵ Thus, a mortgagee possesses both legal and equitable title from the assignment and recording of a mortgage for personal property.¹⁵⁶ The *Waterman* court further held that as the complete title holder to a patent, the mortgagee possesses the exclusive right to bring an action of

147 138 U.S. 252 (1891).

148 *Waterman* utilized the recording statute present in the Patent Act of 1870; see *supra* note 146.

149 138 U.S. at 260.

150 *Id.* at 258.

151 *Id.* at 258-59.

152 *Id.* at 259.

153 *Id.*

154 *Id.*

155 “When it is provided by statute that a mortgage of personal property shall not be valid against third persons, unless the mortgage is recorded, a recording of the mortgage is a substitute for, and . . . equivalent to, a delivery of possession, and makes the title and the possession of the mortgagee good against all the world.” *Id.* at 260.

156 *Id.*; see also *Procter & Gamble Co. v. Kimberly-Clark Corp.*, 684 F.Supp. 1403, 1405 (N.D. Tex. 1987).

infringement.¹⁵⁷ In addition, the mortgagee has the ultimate authority to license and receive royalty payments from the patent.¹⁵⁸ [33]

An assignment under the patent recording statute must grant the transferee *all rights* to make, use and sell the invention.¹⁵⁹ Furthermore, the transfer must be a “present assignment” of an existing interest.¹⁶⁰ An existing interest may be an issued patent,¹⁶¹ a patent application,¹⁶² or an expectant interest to a patent or patent application.¹⁶³ In contrast to a “present assignment” of an existing or expectant interest, a promise of a future assignment, an “agreements to assign,” vests the transferee with only equitable rights in the patent.¹⁶⁴ By their very nature, liens and security interests are “agreements to assign,” because they condition any assignment of legal title on the debtor’s default. A lien or security interest fails to vest the creditor with legal title to the invention as of the time the debtor obtains

¹⁵⁷ *Waterman*, 138 U.S. at 160. Exclusive licensees can now bring an action of infringement. See *infra* note 236 and accompanying text.

¹⁵⁸ *Waterman*, 138 U.S. at 260.

¹⁵⁹ *Id.* at 256. See also *CMS Indus., Inc. v. L.P.S. Int’l, Ltd.*, 643 F.2d 289, 294 (5th Cir. 1981) (“Where an agreement effectively transfers the entire bundle of rights residing in a patent, that agreement is an assignment, not a license.”).

¹⁶⁰ A present assignment of an existing interest or invention is required to transfer to the assignee all legal and equitable rights. *Arachnid, Inc. v. Merit Indus., Inc.*, 939 F.2d 1574, 1580 (Fed. Cir. 1991).

¹⁶¹ See 35 U.S.C. § 261 (“Applications for patent, patents, or any interest therein, shall be assignable in law by an instrument in writing.”).

¹⁶² *FilmTec Corp. v. Allied-Signal Inc.*, 939 F.2d 1568, 1572 (Fed. Cir. 1991) (“Once the invention is made and an application for patent is filed . . . legal title to the rights accruing thereunder would be in the assignee . . .”); *Gayler v. Wilder*, 51 U.S. (10 How.) 477, 13 L. Ed. 504 (1850) (“the thing to be assigned is not the mere parchment on which the grant is written. It is the monopoly which the grant confers And when the party has acquired an inchoate right to it . . . the assignment of his whole interest, whether executed before or after the patent issued, is equally within the provisions of the act of Congress.”).

¹⁶³ Under an assignment of an expectant interest, the assignee/creditor receives legal title in the resulting patent automatically from the moment the debtor/assignor’s legal right to the patent has vested. See *FilmTec*, 939 F.2d at 1572. Furthermore, the assignee holds an “equitable title” to the invention prior to the creation of the legal interest in the debtor. *Id.*

¹⁶⁴ *Arachnid*, 939 F.2d at 1581 (“An agreement to assign in the future inventions not yet developed may vest the promisee with equitable rights in those inventions once made, such an agreement does not by itself vest legal title to patents on the inventions in the promisee . . .”).

legal title. Hence, a security interest fails to meet the “present assignment” requirement of the patent recording statute.¹⁶⁵ [34]

Thus, liens and Article 9 security interests do not fall within the language of section 261. Furthermore, when a creditor records a “mortgage” on a patent, the creditor is deemed to have both equitable and legal title to the patent.¹⁶⁶ The mortgage nullifies the assignment upon payment of the debt.¹⁶⁷ However, upon repayment of the debt, the debtor only regains equitable title until a formal transfer of legal title is made by the creditor to the debtor.¹⁶⁸ [35]

B. *Methods Of Utilizing Collateral Assignments*

A mortgage that vests legal title in the creditor (“collateral assignment”) is the only recordable security interest under section 261. Criticism of the collateral assignment has centered on the creditor’s burden of having to acquire legal title to the patent.¹⁶⁹ Prior to recording, a collateral assignment requires some formalization of the loan transaction, because the creditor must record the assignment agreement transferring legal title to the patent.¹⁷⁰ In return, the creditor grants the debtor an exclusive license to practice the invention.¹⁷¹ Unlike Article

¹⁶⁵ See *In re Transportation Design*, 48 B.R. at 639 (holding that a grant of a security interest is not a conveyance of a present ownership interest).

¹⁶⁶ *Waterman*, 138 U.S. at 258.

¹⁶⁷ *Id.* at 258.

¹⁶⁸ See *Railex Corp. v. Joseph Guss & Sons, Inc.*, 40 F.R.D. 119, 122 (D.D.C. 1966); *aff’d*, 382 F.2d 179 (D.C. Cir. 1967).

¹⁶⁹ Where the debtor needs ongoing financing and periodically acquires new available collateral, the federal approach requires multiple document preparations and multiple filings whereas the U.C.C. requires only one. Economically significant financing today tends to be ongoing and fluid, not discrete. In ongoing financing, the transactional approach involves considerably more expense than the [Article 9] notice filings approach because the transactional approach involves multiple trips to the filing office, while notice filing requires only one.

Nimmer & Krauthaus, *supra* note 9, at 218.; see also *City Bank & Trust Co.*, 83 B.R. at 783 (“the federal recording system would, in effect, reinstitute a “title theory” of security interests and thereby diminish the potential of patents as collateral”).

¹⁷⁰ See *Weinberg & Woodward*, *supra* note 7, at 75.

¹⁷¹ See *Mesrobian & Schaefer*, *supra* note 8, at 336.

9,¹⁷² the creditor cannot record a statement covering the security interest prior to formalizing the loan agreement, because the PTO requires the actual assignment agreement to be filed.¹⁷³ As a result, the parties are forced to contemplate and bargain for their post-filing position prior to filing the assignment agreement. [36]

However, creditors who utilize patents as security can gain many essential advantages through a collateral assignment.¹⁷⁴ In contrast to a security interest, a collateral assignment allows a creditor to exercise considerable control in protecting the value of a patent. For example, the creditor, as holder of legal and equitable title, has standing to bring infringement actions.¹⁷⁵ However, the creditor does not necessarily have to incur the costs of preserving the value of the patent by being burdened with policing the patent. As an exclusive licensee, the debtor also has the ability and the incentive to police the patent without the permission of the creditor.¹⁷⁶ [37]

Furthermore, the creditor may structure the licensing agreement to acquire additional control over the value of the patent. The value of the patent will diminish as a result of improper use by the debtor.¹⁷⁷ The licensing agreement can provide the creditor with flexibility in dealing with the debtor and the use of the patent. For example, the creditor may reserve the right to re-license the patent to

¹⁷² Article 9 permits the filing of a financing statement that can preserve a creditor's priority in after-acquired property. See *infra* notes 45-52 and accompanying text.

¹⁷³ See Weinberg & Woodward, *supra* note 7, at 75.

¹⁷⁴ See *infra* Part IV (discussing many policies that must be preserved under patent law whenever considering a patent scheme).

¹⁷⁵ See *Waterman*, 138 U.S. at 260 (holding that the right to bring infringement suits is attached to the holder of legal title); see also 35 U.S.C. § 271 (1994) (granting right to bring infringement suit to a "patentee," who is defined to be the owner of the patent under 35 U.S.C. § 100(d)).

¹⁷⁶ An exclusive licensee may bring infringement actions without the permission of the creditor. See *Calgon Corp. v. Nalco Chemical Co.*, 726 F. Supp. 983, 988 (D. Del. 1989) ("The exclusive licensee should, in equity, be able to commence an action for infringement when the patent owner refuses to vindicate his rights.").

¹⁷⁷ *Crestar Bank v. Comband Technologies Inc.*, 1995 U.S. App. LEXIS 31064, at *9-10 (4th Cir. 1995) ("When the property subject to a security interest is intellectual property, preservation of the value of the business as a going concern can be essential . . . to preserve the value of the property. Intellectual property cannot be mothballed until a buyer materializes. Often buyers can measure the value of intellectual property only by examining what cash flow that property is currently generating for the business. Moreover, the value of intellectual property can evaporate entirely if the business that owns the property stops operations.").

other corporations in conjunction with the licensing agreement with the debtor.¹⁷⁸ As a result, the creditor may preserve and promote the value of the patent without causing irreparable injury to the debtor. [38]

C. Security Interests And Liens In The Federal Recording System

While section 261 fails to explicitly provide for either security interests or liens, a creditor who wishes to record and perfect such an interest is not necessarily precluded from using the federal system. Section 261, as interpreted by *Waterman*, excludes security transfers that fail to rise to the level of an assignment.¹⁷⁹ By equating the act of recording a mortgage with the mortgagee taking possession, *Waterman* sought to provide a creditor with the means to fully protect the value of the collateral.¹⁸⁰ As such, *Waterman* held that creditors who had mortgages on patents must be able to protect the value of the patent through judicial enforcement and licensing. However, a collateral assignment is no longer the exclusive means by which a creditor can obtain a security interest under the federal patent system. [39]

Under modern practice, creditors may acquire security interests that are less than assignments.¹⁸¹ The PTO permits creditors to record security interests.¹⁸² The question remains as to whether recording a security interest with the PTO provides constructive notice of the interest against subsequent purchasers of the patent.¹⁸³ [40]

Apart from the statutory language of section 261, common law justifies the ability of a creditor to perfect his security interest against third parties by recording the interest under the federal system. Security interests are equitable interests that encumber the title of the collateral. Patent law incorporates the common law rule that an equitable interest in a patent survives a subsequent assignment if the assignee is on “inquiry notice” that the equitable interest exists.¹⁸⁴ Once an assignee is on “inquiry notice,” the assignee has an affirmative duty to investigate whether

¹⁷⁸ See *Waterman*, 138 U.S. at 260 (“the assignee of a patent by mortgage must be held entitled to grant licenses, to receive license fees and royalties, and to have an account of profits or an award of damages against infringers”).

¹⁷⁹ 138 U.S. at 260.

¹⁸⁰ *Id.*

¹⁸¹ See Nimmer & Krauthaus, *supra* note 9, at 207.

¹⁸² See *supra* notes 23-37 and accompanying text.

¹⁸³ See Weinberg & Woodward, *supra* note 7.

¹⁸⁴ *FilmTec*, 939 F.2d at 1573-74.

the equitable or legal interest exists.¹⁸⁵ The PTO has devised a federal system that automatically places all interested third parties or assignees on “inquiry notice” of any existing security interest. First, the PTO permits the filing of security interests if the security interests refer to a specific patent or patent application by number.¹⁸⁶ Second, the federal patent system is sufficiently complex to require all interested and reasonable participants to review the assignment and title history of the patent.¹⁸⁷ Investigating the procedural history and chain of title of a patent requires a single search based on the patent or patent application number. Such a search should reveal a recorded security interest. The assignee must then acquire the patent subject to the “equitable” security interest.¹⁸⁸ [41]

Under the federal system, “inquiry notice” arguably imposes a duty on all interested third parties and assignees to search the title of a patent. The existence of a security interest will be revealed to a third party in an ordinary and necessary procedural check. The “inquiry notice” doctrine adopted by the patent system, combined with PTO regulations allowing for recordings of security interests, allows creditors to provide constructive notice to the public. [42]

IV. PATENT AND U.C.C. POLICIES FAVORING PREEMPTION OF ARTICLE 9

Regardless of what interest a creditor files under the federal patent system,¹⁸⁹ the creditor can be protected under section 261. As mentioned, the issue of federal preemption over Article 9 is still unclear.¹⁹⁰ However, patent and secured

¹⁸⁵ *Id.*

¹⁸⁶ *See supra* notes 28-30 and accompanying text.

¹⁸⁷ For instance, a reasonable potential assignee should investigate the procedural history of a patent to check for proper payment of the patent’s maintenance fees, or to ensure that all of the inventors have properly assigned their interests to the assignees on record. *See infra* notes 235-241 and accompanying text.

¹⁸⁸ *See FilmTec*, 939 F.2d at 1575.

¹⁸⁹ *See supra* notes 143-77 and accompanying text for a discussion on the effects of recording a collateral assignment, mortgage, and security interest.

¹⁹⁰ To summarize the scarce case law: (1) Article 9 perfected security interest versus lien creditor: Article 9 governs. *See In re Transportation Design*, 48 B.R. 635; *City Bank & Trust Co.*, 83 B.R. 780. (2) Article 9 perfected security interest versus subsequent purchaser for value and without federal notice: Article 9 is preempted. *See In re Transportation Design*, 48 B.R. 635; *City Bank & Trust Co.*, 83 B.R. 780; but *contra Holt*, 13 U.C.C. Rep. Serv. 336. (3) Unrecorded assignment versus subsequent Article 9 perfected security interest: unrecorded patent is valid against all third parties except for mortgagees and assignees. *See Why Corp. v. Super Ironer Corp.*, 128 F.2d 539. (4) Article 9 perfected security interest versus purchaser with notice of the security interest: unresolved, but common law indicates that

transaction policies favor the preemption of Article 9 by the federal system, even if the federal system is construed in its most limited form to give protection only to collateral assignments.¹⁹¹ Commentators argue that section 261 fails to comprehensively govern security interests created under modern secured transactions.¹⁹² Specifically, they criticize the federal system as too formal and focused on transactions, because loan agreements must be completed prior to financing, resulting in increased costs.¹⁹³ [43]

The availability of Article 9 filings for security interests in patents undermines specific policies and provisions of the Patent Act. As stated by the *In re Peregrine* court, “this type of direct interference weighs heavily in favor of preemption.”¹⁹⁴ This Part discusses the patent policies and provisions that are hindered by the conflict with Article 9. This Part further discusses how the interests of Article 9 are minimized when patents are used as collateral. This Part concludes that policies and provisions underlying both the Patent Act and Article 9 weigh heavily in favor of fully preempting Article 9. [44]

A. A Choice Between A Dual Recording System And A Federal System

Absent federal preemption, a redundant dual recording system will result.¹⁹⁵ Creditors filing a security interest must conduct a federal search to ensure that the debtor is the owner of a valid patent or patent application in good standing. For example, an abandoned patent application,¹⁹⁶ or the improper payment of maintenance fees on an issued patent, can render a patent invalid.¹⁹⁷ The informed

the purchaser would take title to the patent with notice of the security interest. *See supra* discussion accompanying notes 183-87.

¹⁹¹ *See* discussion *supra* accompanying notes 159-68 for how the federal system can be interpreted to be limited to collateral assignments.

¹⁹² *See, e.g.,* Nimmer & Krathaus, *supra* note 9.

¹⁹³ *Id.*

¹⁹⁴ *In re Peregrine*, 161 B.R. at 199 (citing *Bonito Boats, Inc. v. Thunder Craft Boats, Inc.*, 489 U.S. 141, 109 S.Ct. 971, 103 L.Ed.2d 118 (1989)).

¹⁹⁵ *See* Weinberg & Woodward, *supra* note 7, at 66-67.

¹⁹⁶ *See* DONALD S. CHISUM, PATENTS, § 6.03 (1995).

¹⁹⁷ For example, the assignee may have mistakenly declared “small entity” status, which is grounds for invalidating the patent under fraud. *See* 37 C.F.R. § 1.9 ; MAN.PAT.EXAM.PROC. § 509.03 (1995).

creditor may also need to search the federal system for competing patents pertaining to the collateralized patent.¹⁹⁸ A federal search of related patents is integral for determining the validity of the patent in question.¹⁹⁹ Federal preemption becomes a choice between a single federal recording system and a dual recording system that treats assignments and security interests separately. [45]

The federal recording system plays an important role in the realm of secured transactions, even in a dual recording system. Specifically, the federal recording system is necessary for determining the ownership and value of patents, which have increasingly become valuable assets for corporations.²⁰⁰ Different types of patents have different values. For example, a patent may be an improvement patent, which may be blocked by a senior patent. The collateral value of an improvement patent is diminished because the improvement patent owner must obtain a license or cross-license from the senior patent owner in order to utilize the senior technology. The improvement patent's value, however, will be less diminished if the senior patent is close to expiration, or is potentially invalid.²⁰¹ Therefore, in order to ensure the collateral patent's validity, and assign an accurate value, creditors must rely heavily on a federal recording system. [46]

Such considerations clearly show that, absent preemption of Article 9, a dual recording system is a disservice to creditors. Currently, a creditor must search the federal system, as well as the U.C.C. filing offices, to ensure priority in the patent or patent application.²⁰² For the fully informed creditor who wishes to secure an interest in a patent, Article 9 adds an inefficient cost that burdens secured transactions. [47]

¹⁹⁸ Strategies for developing new companies with patents are often foiled by blocking patents, which result in cross-licensing schemes that still may be valuable if researched and planned correctly. Robert L. Cook, *The Software Industry Anticipates a Flood of Patent Litigation*, NATL. L.J., Jan. 24, 1994, at 52.

¹⁹⁹ "Intellectual property has grown increasingly important as it assumes a larger proportion of the value of American business. To maximize these assets, a company's intellectual property must be properly valued . . . it is essential to ensure that the company's new process or product will not violate any valid patents owned by others." Richard Delucia & Steven J. Lee, *Count All Your Blessings*, LEGAL TIMES, Dec. 19, 1994, at 18.

²⁰⁰ "In reviewing patents . . . an attorney must assess the competition's intellectual property rights, which often provide valuable insight into the market." Mark V. Boennighausen, *Patent Sleuths Scope Out Value For Investors*, THE RECORDER, July 7, 1995, at 4.

²⁰¹ Besides procedural flaws, typical reasons patents are invalidated are obviousness, 35 U.S.C. § 103 (1994), lack of novelty, 35 U.S.C. § 102 (1994), or failure to meet the "best mode" requirement. 35 U.S.C. § 112 (1994).

²⁰² See Nimmer & Krauthaus, *supra* note 9, at 215.

Furthermore, a senior creditor's arbitrary perfection of a security interest under Article 9 could impede the potential for other creditors to investigate the value of the patent. A permissible Article 9 filing would preserve the right of the senior creditor against subsequent creditors and possibly assignees. Thus, a co-existing recording system creates an incentive for the senior creditor to assign minimal collateral value to a patent whenever possible. [48]

The debtor generally has the burden of proving the value of a patent to a creditor in a secured transaction. Typically, new high technology companies have undervalued patents.²⁰³ The company, however, may not be able to afford the high costs of properly valuing the patents through the use of experts and their speculative techniques.²⁰⁴ As a result, a debtor may be forced to accede to the creditor's request to blanket all property in the debtor's possession with a security agreement.²⁰⁵ The senior creditor has nothing to lose by claiming priority in the collateral patent without ever investigating the patent's value. A subsequent creditor, however, realizing the worth of the patent, will not enter into a transaction without having priority in the collateral. A fair and effective secured transaction scheme must encourage the participants to investigate the value of the collateral patent that they subject to a priority claim. [49]

B. *Areas of Direct Conflict Between the U.C.C. and Section 261*

Two areas of the federal recording system directly conflict with the provisions of Article 9. First, the federal recording system gives the "assignee"²⁰⁶ a three-month look back period.²⁰⁷ Article 9, however, generally resolves priority disputes by the first-to-file rule, without providing the three-month look back period.²⁰⁸ If

²⁰³ "Technology-oriented companies typically have minimal tangible assets, but often possess significant, if undeveloped, intellectual property assets." See Mesrobian & Schaefer, *supra* note 8, at 336.

²⁰⁴ See Boennighausen, *supra* note 200, at 3 (highlighting the expensive cost of evaluating patents).

²⁰⁵ For example, a recent insolvent high-technology company's patents fetched ten times their expected value at a foreclosure sale, enabling the secured creditor to be repaid in full. See Boennighausen, *supra* note 200.

²⁰⁶ Assuming the "assignee" includes the creditor who retains a security interest or mortgage, that is an "assignment" under patent law.

²⁰⁷ The assignee can wait three months from the date of the assignment's execution to record the interest and the recorded interest will be effective against all subsequent assignments. 35 U.S.C. § 261 (1992). See *supra* notes 34-37 and accompanying text.

²⁰⁸ U.C.C. § 9-312(5)(a).

Article 9 perfection permits a security interest to continue and be good against a subsequent assignment, state courts must develop judicial doctrine to account for the three-month look back period in order to avoid direct conflict with federal law.²⁰⁹ This situation raises more issues, because the three-month look back period will not be applied uniformly in various scenarios.²¹⁰ Furthermore, this direct conflict between Article 9 and section 261 will result in uncertainty and non-uniformity among the state jurisdictions. Most importantly, the resulting vague and non-uniform law will conflict with the federal patent system's policy of certainty and disclosure of patent ownership. [50]

Second, the federal patent system is simply too different to co-exist with Article 9. The federal system provides a single recording office where "documents affecting title" to a patent are recorded.²¹¹ In contrast, Article 9 spreads the relevant search offices throughout the various jurisdictions of the states. Furthermore, Article 9 requires the public to search for security interests by name of the debtor in the debtor's location.²¹² The extreme difference between the two systems is also illustrated by Article 9's use of a broad financing statement, which allows the creditor to claim all present or after acquired property of the debtor.²¹³ [51]

Article 9's three features of decentralized search offices, debtor name searches, and use of broad financing statements directly conflict with the federal policy of determining ownership interests in patents with certainty.²¹⁴ Under Article 9, a record searcher faces considerable risk of error in determining the legal title to a patent. For example, consider a hypothetical searcher who simply needs to determine whether a senior creditor exists. First, the chain of title to the patent or patent application must be determined to ensure that the debtor is the true owner of the invention. The search begins with the inventor²¹⁵ of the invention, or

²⁰⁹ With respect to ownership interests, "state law must yield only when it would create a serious conflict with federal patent policy." CHISUM, *supra* note 196, § 22.03[4].

²¹⁰ Consider instances where two creditors file Article 9 perfected security interests within three months; or when a security interest is perfected after an assignment of the patent, and the assignee had yet to record the assignment with the PTO because of the three month look back period.

²¹¹ 37 C.F.R. § 3.11.

²¹² See *supra* notes 54-55 and accompanying text.

²¹³ See *supra* notes 51-53 and accompanying text.

²¹⁴ See Weinberg & Woodward, *supra* note 7, at 76.

²¹⁵ "Inventorship provides the starting point for determining ownership of patent rights." CHISUM, *supra* note 196, § 22.02.

inventors who initially shared joint tenant interests in the patent.²¹⁶ The searcher must then examine federal records for all subsequent assignees of the patent. For each assignee, an Article 9 search must also be conducted in that assignee's location for security interests granted to creditors. The searcher must also investigate financing statements covering after-acquired property filed during the previous five years, which may include the patent in question.²¹⁷ A financing statement covering an assignee puts the searcher on notice of a possible security interest. The searcher must contact the secured party to inquire about the security agreement, and possibly interpret its language to see if it covers the patent in question.²¹⁸ In addition, the status of the debtor/assignee's loan may have to be determined through the interpretation of the loan agreement's terms. [52]

Along the way, the searcher must hope that the debtor has used a single name,²¹⁹ and that all the debtor's possible domiciles in the past five years have been searched.²²⁰ And if there is a mistake in the search, the searcher may incur an unexpected injury resulting from a non-conforming state law application of Article 9. In addressing the issue of Article 9 preemption by the Copyright Act, Judge Kozinski, in *In re Peregrine Entertainment*, stated that "to the extent interested parties are confused as to which system is employed, this increases the risk of error, exposing creditors to the possibility that they may get caught with their pants down."²²¹ [53]

C. *Protecting Licensees Through a Single Federal System*

The Patent Act is an incentive system designed to benefit the public.²²² To achieve this purpose, the public sacrifices the right to profit from an idea that was once available to all by granting a patent. In return, the patentee discloses the invention to the public, and provides beneficial use of the invention through its

²¹⁶ See *id.* § 22.01.

²¹⁷ See *supra* notes 50-54 and accompanying text.

²¹⁸ See *supra* notes 52-54 and accompanying text.

²¹⁹ U.C.C. § 9-402(7).

²²⁰ U.C.C. § 9-403(3).

²²¹ *In re Peregrine Entertainment*, 116 B.R. at 201.

²²² See 35 U.S.C. § 200 (1992).

promotion in a monopolistic market environment.²²³ State law may not impede the Patent Act's incentive system. Under a proper preemption analysis, one must weigh the consequences of such impediment against the state interest in preserving its laws.²²⁴ [54]

Preserving the benefits of patent licensing should be weighed when balancing the policies of patent law with the interests behind state regulations. As a result, the interests of licensees must be considered in determining the extent of federal preemption over Article 9. This Part discusses the reasons why licensees must rely on recording systems to protect their interests. Furthermore, licensees face many hazards as a result of the existence of the Article 9 filing system. As such, promoting patent licensing favors fully preempting Article 9 with respect to patents. [55]

1. The Emerging Importance of Patent Licensing

The expanded role of patents has coincided with the creation of the Court of Appeals for the Federal Circuit ("Federal Circuit"), which has exclusive appellate jurisdiction to hear issues arising under patent law.²²⁵ The Federal Circuit provides a uniform application of patent law by capable judges.²²⁶ As a result, patent owners are now more willing to enforce their patents, and to initiate infringement actions.²²⁷ Furthermore, companies have expanded their patent portfolios in order to raise revenue from licensing and cross-licensing.²²⁸ [56]

²²³ "Whoever invents or discovers any new and *useful* process, machine, manufacturing, or composition of matter, or any new and *useful* improvement thereof, may obtain a patent therefor, subject to the conditions and requirements of the title." 35 U.S.C. § 101 (emphasis added).

²²⁴ See *Bonito Boat v. Thunder Craft Boats, Inc.*, 489 U.S. 141, 167 (1989) (emphasizing the patent statute's careful balance between public right and private monopoly).

²²⁵ Congress created the Federal Circuit with the Federal Courts Improvement Act of 1982, Pub. L. No. 97-164, 96 Stat. 25 (April 2, 1982). The reasons for creating the Federal Circuit were principally to reduce the work load of the other circuit courts, as patent cases were consuming judicial resources due to their complexity; to create uniformity in the area of patent law; and to use judicial resources more effectively. See H.R. REP. 97-312, 97th Cong., 1st Sess. (1981).

²²⁶ For example, the creation of the Federal Circuit has resulted in the assertion of the presumption of patent validity, see *Am. Hoist & Derrick Co. v. Sowa & Sons, Inc.*, 220 U.S.P.Q. (BNA) 763 (Fed. Cir. 1984); clarification of secondary factors to determine obviousness, *Stratoflex Inc. v. Aeroquip Corp.*, (Fed. Cir. 1983); and analysis of infringement by comparing the patent as a whole to the accused device, *W.L. Gore & Assoc. Inc. v. Aeroquip Corp.*, (Fed. Cir. 1983). See Daniel F. Perez, *Exploitation and Enforcement of Intellectual Property Rights*, THE COMPUTER LAWYER, August, 1993, at 10.

²²⁷ In response to demands for better patent enforcement procedures, the "U.S. courts took note. In the 1980's, with the formation of the U.S. Court of Appeals for the Federal Circuit, patents began to be upheld at a far greater rate. Some 75 percent of patent infringement cases are now won by patent holders . . . both patent filings and patent litigation have surged. In 1993, a record 1,447 patent suits

Companies have begun to stockpile patents in the hopes of maximizing their leverage to license in the future.²²⁹ The incentive to stockpile patents correlates to the patentee's ability to collect monetary damages far in excess of their cost.²³⁰ Patent law permits a patentee to collect monetary damages for infringement, even if the patentee has not developed a product or use for the patent.²³¹ Consequently, the patentee can keep a vigilant eye for possible infringing activities, and use the possibility of expensive monetary damages, coupled with an injunction against an infringer, to leverage its bargaining position to license. [57]

As a result, the inherent value of a patent to one entity is a function of its use by other participants in the specific market in developing the patent's resulting technology. Consequently, entities interested in acquiring patents are no longer limited to their respective technological areas. The patentee may enforce her rights against infringing non-competitors in a technological area in which the patentee is not a direct participant. The creation of the Federal Circuit, and the increased

were brought in U.S. courts, 23% more than in previous year." Kevin Rivette & Orving Rappaport, *Golden Opportunities*, LEGAL TIMES, Dec. 19, 1994, at 11, 16.

228 See *Perez*, *supra* note 226, at 10 (in response to fierce competition, "[l]arge corporations that aggressively expand their patent portfolios with large-scale R & D programs are generally in a position to license their technology for royalty revenues and to establish cross-license agreements with other corporations."); Miram Rozen, *Texas Instruments's \$ 250 Million-A-Year Profit Center*, AMERICAN LAW JOURNAL (March, 1992) (Texas Instrument pioneers aggressive scheme to ten-fold licensing revenue, utilizing threat of infringement litigation).

229 At a recent foreclosure sale, a bankrupt high-technology company sold its patents at an enormous price because "high-tech companies are eager to amass war chests of patents that they can hold in reserve for future litigation." See Mark V. Boennighausen, *Bankrupt Orca Finds Buried Treasure; Creditors Receive Windfall When Litigation-Wary High-Tech Companies Bid Millions of Dollar for the Disk-Drive Makers Patent*, THE RECORDER, April 14, 1995.

230 See *Perez*, *supra* note 226 (citing to recent court decisions awarding patent holder hundreds of millions of dollars for successfully pursuing infringement actions).

231 Traditionally, the patentee relies on a "reasonable royalty standard," which is calculated as a function of the infringer's actual and anticipated profit in a hypothetical negotiation between the licensee and the patentee. CHISUM, *supra* note 196, § 23.03[3]. The Patent Act incorporates "the reasonable royalty" standard as a minimum standard for rewarding monetary damages. "[U]pon finding for the claimant the court shall award the claimant damages adequate to compensate for the infringement, but in no event less than a reasonable royalty for the use made of the invention by the infringer." 35 U.S.C. § 284; see, e.g., *TWM Mfg. Co. v. Dura Corp.*, 789 F.2d 895 (Fed. Cir. 1986) (calculating damages based on the "reasonable royalty standard," which included anticipated profits). In 1992, Honeywell Corporation collected \$303 million from eleven camera manufacturers for infringement, despite the fact that Honeywell had never utilized the patent to produce its own product. See, Rivette & Rappaport, *supra* note 227.

monetary value of patents, has resulted in an environment conducive to purchasing, acquiring and licensing patents.²³² [58]

2. Licensee's Reliance on the Federal Recording System

Despite the emergence of patent licensing, licensees have a limited ability to protect and enforce their interests. In general, a license resembles an easement on a patent, where the licensee is allowed to use the patent in accordance with the licensing agreement, without being liable for infringement.²³³ A licensing agreement generally allows the licensee to manufacture, sell goods or processes under the patent, or to use a patent for a specific purpose.²³⁴ Only an exclusive licensee, however, can sue for infringement.²³⁵ A non-exclusive licensee, on the other hand, must rely on the patentee to enforce the patent.²³⁶ [59]

In order to protect their interests, licensees must foresee situations that can potentially limit or threaten their limited rights. Licensees rely heavily on the federal recording system to determine existing legal and equitable interests in patents. For example, a licensee must confirm that the license was granted with the

²³² “Increasingly, savvy companies are using patents to protect market share, drive competitors out of niches, and boost bottom lines through lucrative judgments and licensing fees. Venture capitalists are scouring patent filings to determine where to invest their money long before the market takes shape.” Rivette & Rappaport, *supra* note 227, at 12. Some of the largest companies currently license their patents for sums approaching a billion dollars annually. *Id.*

²³³ RISDALE ELLIS, A TREATISE ON THE LAW OF PATENT ASSIGNMENT AND LICENSES 7 (1936).

²³⁴ *Id.*

²³⁵ An exclusive licensee can bring an infringement suit, even without the permission of the patentee. See CHISUM, *supra* note 196, § 21.03[2][c]. “An exclusive licensee generally has standing to sue for infringement against anyone operating without authority in the stated area of exclusivity. This is so even though the patent owner/licensor refuses to join voluntarily.” *Id.*

²³⁶ In its simplest form, a license means only leave to do a thing which the licensor would otherwise have a right to prevent. Such a license grants to the licensee merely a privilege that protects him from a claim of infringement by the owner of the patent monopoly He has no property interest in the monopoly of the patent, nor any contract with the patent owner that others shall not practice the invention. Hence the patent owner may freely license others, or may tolerate infringers, and in either case no right of the patent licensee is violated. Practice of the invention may indeed cause him pecuniary loss, but it does him no legal injury.

Western Elec. Co. v. Patent Reproducer Corp., 42 F.2d 116, 118 (2d. Cir.), *cert. denied*, 282 U.S. 873 (1930); see also *Life Time Doors, Inc. v. Walled Lake Door Co.*, 505 F.2d 1165 (6th Cir. 1974) (non-exclusive licensee could not appeal finding patent is not infringed and invalid).

authority of the legal title holder of the patent.²³⁷ The licensee may also have to verify that the patent or patent application is in good standing with the PTO.²³⁸ In addition, the licensee may need to determine the validity of the patent, which requires a search in the patent recording system for prior art. [60]

Furthermore, in determining the value of a licensing agreement, a licensee must know the scope of the her rights. A federal patent search reveals similar inventions that might lead to future competition, or prevent the licensee from expanding its market.²³⁹ The licensee must also search for “blocking patents.” The existence of a “blocking patent” diminishes the value of the licensing agreement for the licensee, because the licensee must cross-license or pay royalty to the senior patentee.²⁴⁰ [61]

3. Licensee Problems Arising From a Dual Recording System

A dual recording system undermines the incentive and ability to utilize a patent through a license. The potential existence of an Article 9 transaction adds an additional impediment to a licensee's incentive to enter into an agreement. A creditor's Article 9 perfected security interest may adversely affect licensees of the same patent for several reasons. Foremost, a licensee must be aware of any perfected security interest in anticipation of the licensor's bankruptcy.²⁴¹ In addition, a previously perfected security interest in the patent may cut off the rights of a subsequent licensee under the unsettled law, should the licensor/patentee default on an obligation secured with the patent.²⁴² The licensee, however, is protected

²³⁷ “Acquiring licensing rights from a party who does not have rights in the patent is a serious concern in the modern licensing market, exposing the licensee to an infringement action.” William A. Tanenbaum, *Intellectual Property Due Diligence for Multi-Media Strategic Alliances*, THE COMPUTER LAWYER, at 1.

²³⁸ See discussion *infra* accompanying notes 192-199.

²³⁹ See generally, ALBERT S. DAVIS, JR., PRACTICAL PATENT LICENSING 21-48 (1966).

²⁴⁰ Cross-licensing provides an incentive for inventors to seek improvement patents. Through the availability of cross-licensing, inventors are encouraged to build on old inventions. See Roger M. Milgrim, MILGRIM ON LICENSING, § 15.42 (1995). A cross-licensing scheme allows the junior user to bargain for permission to use the senior technology. *Id.* Each license in a cross-licensing agreement is generally valued separately. *Id.*

²⁴¹ See *infra* notes 248-65 and accompanying text.

²⁴² Lee A. Schott & Larry C. Sigman, *Preliminary Discussion Draft of Proposed Changes to Article 9 Relating to Treatment of Security Interests in Intellectual Property*, C878 ALI-ABA 415, 434 (Dec. 9 1993) (citing *Report On The ABA Task Force On Security Interests In Intellectual Property*, C878 ALI-ABA (1993)). The Federal Circuit passed on an opportunity to determine the validity of a license granted by a legal title holder who was under an obligation to assign the patent to an equitable title

against the interests of a subsequent perfected creditor.²⁴³ Consequently, the licensee must search for perfected security interests in the patent pursuant to Article 9 prior to entering into a licensing agreement. [62]

Under *In re Transportation Design*,²⁴⁴ a licensee must utilize a dual recording system if she seeks to be completely informed of all possible adverse interests. As discussed earlier,²⁴⁵ a dual recording system increases the risk that the searcher/licensee will overlook an adverse perfected security interest. By failing to discover an interest in a patent prior to entering into a licensing agreement, the licensee could face the adverse consequences of a secured creditor claiming rights to the patent. As a result, the dual recording system could delay the formation of a licensing agreement, and could significantly increase the risk of error in determining all relevant interests in a patent.²⁴⁶ As a result, Article 9 hinders the policies behind the patent system. [63]

4. Licensees Must Plan for the Licensor's Bankruptcy

Licensees must also consider the consequences of bankruptcy or default by a licensor who has entered into a security agreement that uses the patent as collateral.²⁴⁷ If the licensee locates a perfected security interest in the patent, the licensee may seek to protect the license by contracting separately with the creditor in the event of the licensor's insolvency. If the licensee has a non-exclusive interest,²⁴⁸ she may seek assurance from the creditor that infringers will be sued promptly. [64]

Absent an existing recorded security interest in the patent, the licensee may decide to plan for the licensor's potential insolvency prior to entering into the

holder. See *Arachnid*, 939 F.2d at 1577, 1582 (stating that court would not rule on licensee's defense to infringement action brought by legal title holder). The defendant's argument in *Arachnid* would arguably extend to a priority dispute between a license and a security interest, since the defendant claimed that a legal title holder to a patent could grant a license despite the legal title holder's obligation to a pre-existing equitable title claim.

²⁴³ See Schott & Sigman, *supra* note 242.

²⁴⁴ 48 B.R. at 635.

²⁴⁵ See *supra* notes 216-222, 238-39 and accompanying text.

²⁴⁶ See *supra* notes 216-222 and accompanying text.

²⁴⁷ "A licensee of intellectual property may find its rights affected significantly if the licensor files for bankruptcy." Mesrobian & Schaefer, *supra* note 8, at 336.

²⁴⁸ Generally, only exclusive licensees have standing to bring infringement actions. See *supra* note 237.

agreement. Under bankruptcy laws, licensing agreements may be termed “executory contracts”²⁴⁹ by a bankruptcy court.²⁵⁰ Until recently, a licensing agreement that had been declared an executory contract allowed the trustee of the licensor in bankruptcy to terminate the licensing agreement and to license the technology to the licensee’s competitors.²⁵¹ Under the old law, the licensee’s only remedy was to file an unsecured claim with the licensor’s estate.²⁵² Congress responded by enacting section 365 (n) of the Bankruptcy Code,²⁵³ which greatly mitigates the harsh consequences of an executory contract declaration. Under section 365 (n), the licensee may elect²⁵⁴ to retain the rights under the licensing agreement, but the licensor is released from the performance of future obligations.²⁵⁵ The licensee may enforce exclusivity rights against the licensor, but cannot compel the licensor to perform affirmative contractual obligations that burden the debtor’s estate.²⁵⁶ For example, a software licensee cannot compel an insolvent licensor to update, debug or promote the licensed software.²⁵⁷ [65]

When the patent that is subject to a licensing agreement is not covered by a security interest, the licensee may prepare for the licensor’s insolvency in various ways. For instance, if the licensee elects to maintain the licensing agreement upon insolvency, the licensee’s monetary obligation to the insolvent licensor will be owed as “royalty payments.”²⁵⁸ If the licensing fee is structured as a flat monthly fee, the

249 A contract is deemed executory when the “obligations of both the bankrupt and the other party are so far unperformed that a failure of either to complete the performance would constitute a material breach excusing the performance of the other.” *Fenix Cattle Co. v. Silver*, 625 F.2d 290, 292 (9th Cir. 1980).

250 11 U.S.C. § 365(a) (1994).

251 *In re Lubrizol Enter., Inc.*, 756 F.2d 1043, 1048 (4th Cir. 1986) (holding that a technology licensing agreement was an “executory contract”).

252 *Id.*

253 11 U.S.C. §365 (n) (1994).

254 The licensee may also elect to terminate the licensing agreement. 11 U.S.C. § 365(n)(1)(A).

255 David S. Kupetz, *Intellectual Property Issues in Chapter 11 Bankruptcy Reorganization Cases*, 42 J. COPY. SOC’Y. U.S.A. 68, 72 (Fall 1994).

256 *Id.*; see also *In re Fleishman*, 138 B.R. 641 (Bankr. D. Mass. 1992).

257 Kupetz, *supra* note 255.

258 11 U.S.C. § 365(n)(2)(B).

licensee must pay the full amount to the insolvent licensor.²⁵⁹ This is regardless of the fact that the licensee has a “set-off” claim,²⁶⁰ or is no longer entitled to the licensor’s affirmative obligations.²⁶¹ The licensee may avoid overpayment by bargaining a royalty payment based on the licensee’s use or sales, which would more accurately reflect the diminished service the licensee would receive from the insolvent debtor.²⁶² [66]

The licensee may seek alternative methods to mitigate the consequences of the licensor’s potential bankruptcy. If the licensee fails to find a perfected security interest in the patent, she can inspect the licensor’s financial records in order to determine the risk of the licensor becoming insolvent. The licensee may anticipate the licensor’s insolvency by securing the licensor’s contractual obligation with other collateral.²⁶³ In addition, the licensee may find alternative means to acquire equivalent rights to those provided under the licensing agreement.²⁶⁴ [67]

V. CONCLUSION

The extent of federal preemption over Article 9 is ambiguous and confusing. The federal patent system’s provisions that apply to modern security interests are unclear. Recent case law has held that the federal system partially preempts Article 9 provisions with respect to patents. Specifically, case law has held that security interests recorded pursuant to Article 9 perfect the creditor’s security interest against lien creditors, but not subsequent assignees. However, even such limited applicability of Article 9 to secured transactions in patents is detrimental to patent policy. [68]

²⁵⁹ Determining the proper royalty payment is a difficult aspect of licensing, since it requires the evaluation of the patent. Michael Aschen, *Patent Valuation is a Necessary Part of Business; Innovations Increase a Company’s Wealth*, N.Y.L.J., March 27, 1995.

²⁶⁰ 11 U.S.C. § 365(n)(2)(C)(i).

²⁶¹ See *In re Prize Frize Inc.*, 32 F.3d 426 (9th Cir. 1994) (holding that all payments owed by licensee to insolvent licensor must be read broadly as “royalty payments” under section 365(n)).

²⁶² The licensee may even adopt a riskier approach, and label the royalty payments separate from payment for services, or other affirmative obligations. However, courts have indicated that under Section 365(n), parties to a licensing agreement cannot change “royalty payment” by separate definition in a licensing agreement. *Id.* at 429.

²⁶³ Contractual obligations may be secured under Article 9. U.C.C. § 1-201(37).

²⁶⁴ For example, a licensee that vends a product utilizing in part patented technology, may seek alternative means to acquire an equivalent technology that is not covered by the same patent.

The federal recording system is governed primarily by section 261 of the Patent Act, which applies to assignments and mortgages that vest legal title to the assignee or mortgagee. Despite the fact that security interests are not explicitly mentioned in the recording statute, the PTO permits security interests to be recorded. Arguably, security interests recorded pursuant to PTO regulations provide constructive notice to third parties. The federal recording system has become an integral part of every ownership transaction involving a patent. As a result, a security interest filed in the federal system arguably should be effective against all third parties. [69]

Patent policy further supports complete preemption of Article 9 by the federal recording system. Creditors receive adequate protection under even the most limited interpretation of the federal recording system. Furthermore, the presence of an Article 9 recording system conflicts directly with the mechanics and goals of the federal recording system. As a result, patent licensees are left vulnerable in this dual recording system. [70]

In order to best preserve patent policies, while facilitating patent licensing, courts should hold that the federal recording system completely preempts Article 9. [71]