

# **Report and Analysis**

of the

## **Ad Hoc Working Group On Intellectual Property Financing**

regarding the

## **UNCITRAL Draft Legislative Guide on Secured Transactions**

9 January 2007

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## **I. PURPOSE OF THIS REPORT**

The Ad Hoc Working Group on Intellectual Property Financing consists of legal scholars, practicing lawyers, industry professionals and trade association officials who have come together to examine existing legal rules and professional practices for financing intellectual property assets. As a part of their study, the Working Group has examined the draft Legislative Guide on Secured Transactions prepared by the U.N. Commission on International Trade Law (UNCITRAL) and the Convention on the Assignment of Receivables in International Trade sponsored by UNCITRAL.

Intellectual property has become an increasingly important source of value in the global economy. As such, the Working Group supports the goal of enhancing the availability of low cost secured credit to intellectual property creators and owners. The Working Group recognizes, however, that existing secured financing laws are often focused primarily on financing for tangible assets and their related trade receivables. The legal rules and commercial practices that give value to intellectual property assets, however, differ markedly from those for tangible commodities. A modern secured financing regime for intellectual property assets will therefore need to account for these differences.

The Working Group appreciates the initiative that UNCITRAL has shown by hosting a Colloquium on Intellectual Property Financing in Vienna on 18-19 January, 2006. One part of the Colloquium will discuss UNCITRAL's draft Legislative Guide. The Guide acknowledges that, "The primary focus of the Guide is on core commercial assets, such as commercial goods (inventory and equipment) and trade receivables." As such, there is a wide recognition that the recommendations in the draft Guide will need substantial adjustment when the focus shifts to security rights in intellectual property assets and their related income streams. At present, however, the draft Guide does not provide meaningful guidance on how this should be done.

The purpose of this Report is to provide a framework for addressing needed adjustments. The Guide has been in preparation for many years, while intellectual property professionals have only recently been accorded a brief period for review and study. As such, this Report cannot be seen as a definitive statement of all the issues that must be resolved. Rather, the purpose of this Report is to open a dialog on intellectual property asset financing.

This Report is divided into two parts. The first part addresses general principles necessary for an effective regime of intellectual property asset financing. These principles should become the basis for addressing ways in which the recommendations of the draft Legislative Guide will need adjustment for intellectual property assets. The second part presents an overview of the different commercial practices for financing tangible commodities and intangible intellectual property. This section illustrates practical difficulties that can arise both for borrowers and lenders in using inappropriate models to finance intellectual property assets.

The goal of intellectual property law is to accord authors, inventors and initial rightsholders a just reward for undertaking the risks of creativity and invention, and by so doing benefiting the public with new intellectual property. An effective regime of intellectual property asset financing can be a valuable contributor to this goal. By reflecting existing standards for intellectual property law and professional practice, such a financing system can benefit initial rightsholders, transferors and transferees of intellectual property, and end uses. This Report is presented as a contribution to that goal.

## **II. BASIC PRINCIPLES FOR INTELLECTUAL PROPERTY FINANCING**

In this section, the Working Group proposes basic principles needed for effective intellectual property asset financing. Discussions about intellectual property financing often start with the tacit assumption that modern intellectual property assets should fit smoothly within the framework of traditional secured financing law, only to discover conflicts between the requirements of intellectual property law and the expectations of financing law when it comes to practical applications. These conflicts, however, do not arise from “defects” in either body of law as much as from assuming that a financing law made primarily for tangible commodities and their related trade receivables should apply without modification to intellectual property assets and their related royalty streams. It is this assumption that must be critically examined.

A fundamental principle of secured financing law is that the debtor may only use assets as collateral to the extent of the debtor’s rights in those assets. Since a debtor’s rights in intellectual property assets are determined by intellectual property law, the starting point for examining intellectual property asset financing should be the principles that determine when and how these assets may be used as collateral. The purpose of this section is to list several important principles in this regard. This list is not intended to be exhaustive. Rather, the Working Group proposes these principles as an essential beginning for developing an effective framework for intellectual property asset financing.

### **1. Operate Within the Existing Framework of Intellectual Property Treaties, National Laws and Commercial Practices**

A security right allows a secured creditor to take property of a debtor in preference to various other creditors if the debtor defaults on an obligation. As such, a security right is in effect a type of *transfer* of a debtor’s *rights* in property. Secured transactions law does not determine whether the debtor has rights in property or the ability to transfer them to a creditor. The property law for the asset does that. Since property laws differ for different types of assets, it follows that rules for secured financing of varying assets should vary accordingly.

Intellectual property assets arise within a sophisticated array of international conventions, supranational treaties, bilateral treaties, national laws and professional practices. The international conventions create a structure for recognizing intellectual property interests through principles of minimum rights, national treatment, and territoriality. They address transfers by authorizing assignments and licences, as well as controlling some practices, such as compulsory licenses. Supranational conventions harmonize laws of member states, often with more specific requirements regarding recognition of rights and terms of transfers. National laws implement these principles, albeit with some differences in detail, especially between states with a common law legal tradition and those with a civil law tradition. Intellectual property professionals have developed complex national and international practices in reliance on this structure.

This rich framework of intellectual property law and practice determines in the first instance what intellectual property assets are available as collateral and how they can be transferred for security. An effective system of intellectual property secured financing must operate within this existing framework. This requires understanding the principles that support intellectual property commerce and identifying how they differ from those supporting commerce for tangible goods and their related trade receivables. These differences must then be reflected in any workable proposal for intellectual property asset financing.

## **2. Adopt Terminology That Conforms To Existing Intellectual Property Law and Practices**

An effective secured financing regime should utilize terminology that conforms to legal rules and commercial practices for the assets it finances. The draft Legislative Guide uses terminology drawn primarily from practices for tangible commodities and their related trade receivables. While such terminology can be appropriate for those assets, the terminology in the Guide can be inadequate when applied to intellectual property assets.

As a general matter, one can divide intellectual property assets into five categories: initial ownership rights; interests under various types of transfers, including assignments, exclusive licenses and non-exclusive licences; economic rights including royalties and rights of equitable remuneration; rights in physical embodiments and copies; and claims for legal redress, including civil infringement actions and criminal proceedings. Each of these categories can have different rules for the creation, effectiveness, priority and enforcement of a security right. As such, terminology should be developed to reflect these possibilities.

For example, a critical part of intellectual property commerce involves transfers, particularly assignments and licences. An “assignment” is a conveyance of a proprietary interest in intellectual property. Assignments can be outright, such as a conveyance of an existing patent, or conditional, such as conveyance of the copyright in a motion picture to be produced. In common law countries, this is often expressed as the difference between “legal” and “equitable” assignments. A “licence” is a grant of a right to use intellectual property free of infringement claims with respect to specific rights, geographic areas and durations. A licence can be non-exclusive, in which case the licensor can grant other comparable licences, or exclusive, in which case only the licensee may exercise the granted rights within the geographic area for the duration of the licence grant.

An essential component of value for intellectual property is the ability to take legal action against unauthorized users. Usually, only the initial rightsholder or an authorized assignee has such ability. However, in some countries for some types of intellectual property, an exclusive licensee can also take legal action. It should be noted that, in some systems, certain intellectual property rights are considered personal and hence not assignable. However, these systems achieve results similar to an assignment by means of an exclusive license of economic rights. The point is, when using an intellectual property transfer as collateral, it is always essential to identify whether the transferee has a right to pursue infringers, since this will impact the value of the asset. To reflect this value, an effective secured financing regime needs terminology that identifies the different types of intellectual property transfers.

The current draft Legislative Guide does not contain terminology adequate to the task. It uses the term “assignment” solely with respect to receivables. It offers no definitions that reflect the different uses of this term in intellectual property practice. It contains no definition of a “licence,” and only refers to a “licence” in an undifferentiated sense without addressing the differences between exclusive licences and non-exclusive ones. The draft Guide does not distinguish “retention of title claims” from traditional assignments with a right to cancel nor from licences, which by definition involve the retention of title. It does not provide terminology that separates receivables involving a contractual right to performance from licences.

The draft Legislative Guide also lacks other necessary terminology. It does not provide terminology to identify the varying interest of owners, co-owners, joint authors and other parties involved in initial development of intellectual property. It does not differentiate trade receivables from economic rights, including royalties, rights of remuneration and compulsory licence fees. The draft Guide has no terminology for treating physical embodiments of intellectual property apart from traditional goods. It does not indicate whether intellectual property embodiments available in an on-line, electronic form are treated as tangible personal property or otherwise, a matter discussed further below.

Perhaps most importantly, the definition of “intellectual property” in the draft Legislative Guide is not fully consistent with standard usage in international conventions. Instead, the draft Guide defines intellectual property narrowly as limited types of intellectual property and associated licences, without mention of assignments, or economic rights, or rights with respect to embodiments, or claims.

A necessary initial step in crafting recommendations for intellectual property asset financing will be developing a comprehensive glossary of terminology that reflects the variety of intellectual property commercial practices.

### **3. Reinforce the Lender’s Need for Appropriate Due Diligence When Using Intellectual Property Assets as Collateral**

A lender making a loan needs to conduct appropriate due diligence to ensure that a prospective borrower owns or controls the collateral used as security. Due diligence, however, occurs within the legal and commercial context that exists for and gives value to the particular asset. For intellectual property assets the dominant mode of commerce involves licences, which requires consideration of both the license terms and the chain of title.

The first step requires examination of the terms of the relevant licence or transfer under which the borrower acquired the intellectual property rights. Licences are rarely granted for all rights, in every territory, for all time. They are instead limited to precisely defined rights, geographic area and duration. A borrower only gets the actual interest granted in the licence, and a lender in turn gets no more than the borrower-licensee actually has. As such, a lender must examine the terms of the licence to determine the precise interest available as collateral. This includes investigating contractual terms that may restrict assignments or use of the licence as collateral. If the licensed interest is available as collateral, a lender should also verify that the licensee is complying with the licence. Otherwise, a lender might find its security right is ineffective or its enforcement limited. For example, assume a trademark licence authorizes the manufacture and sale of goods under the mark. A lender seeking to enforce its security right in the goods would need to ensure that they were produced in accordance with the licence terms and quality controls, or the goods would be counterfeit and disposing of them an infringement. Similarly, if the licence is for limited duration or territories, an attempt to dispose of the goods after the licence ends or outside the authorized territories can also constitute an infringement.

A lender should also take appropriate steps to deal with a licensor, as a licensor’s conduct can impact the value of the intellectual property. For example, if the lender wants to acquire the going concern value of a business if a debtor defaults, the lender will often need the co-operation of the licensor to provide improvements to copyrighted or patented software, to maintain a brand owner’s quality control standards, to obtain access to current marketing materials, *etc.* Some countries have mandatory requirements for recording trademark licences, without which the licence is invalid, but only the trademark owner can record the licence.

Related intellectual property interests must also be considered. For example, a brand owner will frequently accept limitations on the scope of rights through negotiation with unrelated third parties who own similar rights. Analogous issues arise for patent cross-licences. Bundle cross-licensing is a common practice in some countries, in which case it is necessary for the security right to address all covered interests. Licences can also allow a licensee to adapt intellectual property for new uses, but require the licensee to comply with the rights of others in so doing. In other cases, the intellectual property may incorporate other intellectual property under licence, such as open source software. The point is that a licence is not issued in a vacuum but requires an ongoing relationship with the intellectual property owner within a network of other licences and sublicences.

Once a lender deals with the licensed interest, the second step involves examining the entire chain of title to ensure a valid series of transfers from the initial rightsowner to the borrower. Intellectual property commerce involves an intricate array of contractual undertakings, some of them non-overlapping (exclusive licences) and others overlapping (non-exclusive licences), elaborated through sophisticated tiers of licences, sub-licences and sub-sub-licences to the final end users. It is through these complex contractual webs – the “chain of title” – that rightsowners bring their creations to the public and in turn obtain royalty income needed to remunerate the risks of making new intellectual property. Effective due diligence requires considering the entire chain of title. This is because a licensee only takes the actual rights granted in the licence. As such, a licensee cannot grant a sub-licensee any greater rights than the licensee itself has. For example, a licensee who is only authorized to exercise intellectual property rights in the United Kingdom cannot grant rights in France. Similarly, if A, the initial copyright owner of a movie, grants exclusive broadcast rights to B with the proviso that B may not edit the movie, and B grants broadcast rights to C without mention of such a proviso, C is nonetheless bound by the restriction in the prior licence.

As a result, the retained rights of prior parties in a chain of title continue forward through multiple transfers and subtransfers of rights or change in possession of copies. This means that a junior licensee in the chain of title must consider senior transfers which may limit rights or restrict uses. While this requires due diligence when the licence is made, the licensee gets the benefit when it makes its own sublicences since limitations the licensee imposes will carry forward to its junior sub-licensees. A lender on the intellectual property rights of an intermediate party in the chain of title will be subject to the same obligations but obtain corresponding rights.

Due diligence considerations like the above are commonplace in intellectual property commerce. They are not limited to lenders, of course, since parties taking licences of intellectual property must conduct similar due diligence to ensure the validity of their interest. Parties dealing in this area have developed a number of practices to address these concerns, including establishing standard procedures to investigate chain of title, obtaining errors and omissions insurance, relying on representations and warranties in the licence with appropriate mechanisms to deal with default, and other controls. Lenders loaning against intellectual property assets should understand the utility of adopting comparable due diligence practices.

#### **4. Respect Legal Principles That Enforce Contractual Terms Which Restrict Onward Transfers and Which Allow for Termination.**

Intellectual property law accords rightsholders significant rights to decide by private contract which third parties may use the intellectual property and the conditions for so doing. The international conventions recognize these rights by authorizing intellectual property owners

to make contractual assignments and licences and by providing that in so doing the intellectual rights pass to successors in title. Two common contractual provisions effectuate these rights and make them commercially meaningful.

The first is the ability of a licensor to restrict onward transfers. In many cases, licences of intellectual property involve aspects of personal services that cannot be readily assigned. Moral rights in copyrighted works, for example, are by nature personal and cannot be assigned. For a licensee, the creative abilities of an inventor or an author may be essential characteristics of the licence which cannot be assigned to another. For a licensor, the special abilities of a licensee with regard to servicing or marketing may be essential to realizing value. In such cases, the parties may by contract limit the ability to assign the licence or make further onward licences.

A related issue is the assignment of royalty payments. Many countries have social policy legislation which regulates the ability of creative contributors to assign their royalty entitlements. Other countries have legal rules or commercial practices for collective management of rights and payment of royalties which restrict assignment of royalties outside the collective management system. These laws are adopted to prevent overreaching and ensure commercial efficiency.

The second provision is the ability of a licensor to terminate a licence for breach or other cause. This is a common contractual right. It accords licensors an ability to ensure payment or performance, as continued use of intellectual property after proper termination becomes an infringement. Often, this provision is included with an anti-assignment clause, allowing the licensor to terminate the licence for breach of such a clause.

Of course, licensees often bargain with licensors to waive or limit the exercise of these rights. The point, however, is that recognition of the ability to bargain with respect to these matters facilitates effective commerce and gives value to intellectual property assets. Indeed, recognition of these contractual principles works to the benefit of lenders precisely for these reasons. It is sometimes argued that legal rules should “free up” assets for secured financing by limiting the enforceability of contractual terms that prohibit assignment or that allow termination for unauthorized transfers, at least with regard to security rights. While such an approach has the simple appeal of apparently making it easier to create the security right, for intellectual property assets it can also have the effect of making it harder to enforce the security right. This is because intellectual property assets have a chain of title. As such, rules that limit enforceability of anti-assignment or termination clauses in a licence also limit enforceability of the same clauses in a sub-licence from which significant royalties or performance may be due. In intellectual property commerce, controlling the parties who use the intellectual property is an essential means of realizing value. An effective secured financing regime should respect these practices.

## **5. Affirm That Creating a Security Right in Intellectual Property Assets Requires the Intent of the Parties**

For tangible property *possession* is often the starting point for determining rights, as it is often equated with presumptive ownership or at least the right to pass good title. This leads to policies in which a debtor in possession of goods has rights to use the goods as collateral in preference to parties who merely retain title. The draft Legislative Guide builds on this approach by proposing to convert “retention of title” devices to security rights, even despite the contrary intention of the parties. This would allow debtors in possession of goods to create effective security rights than can prevail over sellers retaining title to the goods as security for payment.

Different policies apply to intellectual property assets. Possessing a copy does not in itself give the possessor any intellectual property rights associated with or enabled by that copy.

Instead, incidents of *title* become the critical determinant of rights in collateral. As a result, it is routine for an intellectual property owner to reserve rights or limit uses when making a transfer. For example, a licensor often retains the right to cancel the licence and recover the intellectual property assets in case of a default in paying royalties. Moreover, a licence by definition involves the retention of title by the licensor since it is common to license limited rights, territories and duration. As such, contractual terms that often appear like “retention of title” claims with respect to tangible commodities are actually a common commercial practice when the attention shifts to intangible intellectual property, and, indeed, are an essential component of intellectual property asset value.

It is possible, of course, to create a security right in intellectual property. In that case, it is necessary to distinguish a transfer for security from other transfers. The common approach in current practice looks to the intent of the parties. This approach conforms to the principles in the international property conventions which allow intellectual property owners to determine the conditions for making transfers.

This difference in underlying property law illustrates the need for different approaches to a security right for different types of assets. For tangible property, the UNCITRAL approach often converts retention of title devices to security rights despite any contrary language by the parties to further policies for this type of property that emphasize possession in preference to title claims. For intangible intellectual property, however, dealing in fractionalized title interests is a routine form of commerce, and as such security rights need to be determined by the expressed intent of the parties.

## **6. Recognize That Competing Claimants for Intellectual Property Assets Differ From Those for Tangible Property**

Secured financing allows a creditor, by taking appropriate steps, to gain priority over competing claimants in the collateral. The types of competing claimants often dictate the steps needed to gain priority and the extent of any priority gained by so doing. However, there can be different competing claimants for different types of property. Thus, it is important to identify carefully in a security regime the competing claimants for each type of property, as this will in turn influence the means necessary for a security right to gain priority and the effect of so doing.

For tangible property assets that do not embody intellectual property, possession is a dominant determinant of rights. Competing claimants to a security right in this type of property include both those who take physical possession of the collateral, as well those who obtain a fictive possession by an appropriate filing. A significant challenger to a security right in this type of tangible property is a judicial creditor who obtains actual possession by appropriate enforcement procedures as such a creditor can often avoid a security right for which a proper filing has not been made.

For intellectual property assets, however, title is a prime determinant of rights. This is because the party who holds “title” to the intellectual property interest is typically the one with legal authority to enforce the rights against infringers. Parties with mere possession of physical copies are not a factor. As such, competing claimants for intellectual property involve parties with competing title interests. However, these parties can differ depending on whether the debtor’s intellectual property interest arises under an assignment or a licence.

As mentioned above, assignments, and in some cases exclusive licenses, can accord the transferee the right to enforce the intellectual property rights against infringers. For simplicity, these types of transfer can be conceived of as “ownership” (or “title”) transfers, since in the usual

case the party with “title” is the one entitled to enforce the rights. For these types of transfers, in some countries, the basic rule is that the first such transfer in time prevails. In this case, the main challenger to a security right is a prior “ownership” transfer. Other countries supplement this “first in time” rule with one that also accords priority to a later “bona fide purchaser” *i.e.*, one who acquires the intellectual property in good faith and for value without notice of a prior competing transfer. To obtain such status usually requires recording notice of the transfer in a national intellectual property filing system. A secured creditor becomes a type of “purchaser” in this system. In both systems, the main challenger to a secured creditor in such an “ownership” interest is a competing “ownership” transfer. Parties who merely take possession of a physical embodiment of the intellectual property do not prevail over the security right.

For licences that do not fall within the previous category, particularly non-exclusive licenses, a different calculus applies. In such cases the primary competing creditor is the licensor, along with, of course, “ownership” claimants that compete with the licensor in the chain of title. This is because a non-exclusive licensee lacks legal authority to maintain an infringement claim. As such, a creditor enforcing its security right against a licensee’s non-exclusive interest may not have authority to stop competing claimants, even the debtor, from continuing to use the intellectual property. The creditor needs the co-operation of the licensor to do that. Thus, the secured creditor needs to make an accommodation with the licensor to achieve effective enforcement in case the secured creditor enforces its rights against the licensee.

A system for financing intellectual property assets must take into account the types of competing claimants that arise for security rights in these types of assets.

## **7. Operate In Harmony with Existing National Intellectual Property Laws to Deal with Means for Providing Notice of a Security Right**

Secured financing law often seeks means for providing effective notice to third parties of the existence of the security right. Giving such notice is often a pre-condition for the security right obtaining priority over competing claimants. This notice, however, needs to operate within the system for providing notice and obtaining priority for all types of transfer for the asset. This is very necessary because ultimately a security right is only valuable if it allows the secured creditor to obtain the debtor’s rights in the collateral free of competing claims. This means the secured creditor after enforcement must be able to establish the validity and priority of its rights in relation to all other transfers for the asset, including those to normal assignees and licensees.

As discussed above, the competing claimants for intellectual property assets are not the same as those for tangible commodities. As such, there are different procedures for giving notice and different priority rules than is the case with tangible assets. These procedures again turn on the type of intellectual property interest, *i.e.*, whether it is an “ownership” interest arising under an assignment or exclusive license, or a non-exclusive license.

With respect to ownership interests under assignments or exclusive licenses, the first step in providing effective notice can involve registration of the intellectual property. This creates an initial starting point against which to index later filings. For patents, rights only arise by government issuance of letters patent. Many countries maintain trademark offices which require filings for effectiveness. Copyrights do not require any registration for subsistence, but some countries maintain copyright offices where parties can register notice of their claim.

Once intellectual property is duly registered, if required, the next step involves recording assignments or other ownership transfers. In some countries, recording an assignment is mandatory to establish a proper successor in title for various types of intellectual property. In

other countries recording establishes priority against innocent third parties or at least provides a presumptive effect. Security rights in intellectual property interests that arise under assignments or exclusive licenses are usually included in this recording system. For example, the Patent Law Treaty provides for filing security rights in national patent offices.

In these systems, filing occurs in the national intellectual property office in the country where the rights are exercised, consistent with the territorial principle in the international conventions. This is a practical approach. Many licences cover multiple countries. Moreover, it is possible to grant multiple licences in the same country for different rights or licence periods. Since value arises from the ability to enforce the intellectual property against infringers, it is important to identify entitled parties in each country where enforcement is sought, rather than in the country of nationality of the licensee-borrower. Otherwise, a lender seeking to identify prior competing claimants may not know where to search for competing claimants.

Non-exclusive licences raise different issues. While a few countries have mandatory requirements for recording trademark licences, for many types of intellectual property, recording of non-exclusive licences is not accommodated at all. Indeed, there are questions about the utility of recording security rights in such licenses at all. Moreover, in many cases there are concerns about fraudulent and piratical filings that argue against filing licences.

## **8. Acknowledge That Economic Rights Are an Essential Component of Intellectual Property**

Intellectual property law recognizes that an essential component of the interest accorded to rightsholders is “economic rights,” which embrace the ability to bargain for and collect royalties. Jurisprudence in both international and national settings affirms this result.

In some cases, the international conventions directly address economic rights. These include provisions authorizing assignments and licenses and restricting various practices involving compulsory licenses. In some cases, the interest accorded rightsholders essentially involves a right of equitable remuneration.

National legislation in many countries also contains provisions that address economic rights. For example, as mentioned above, many countries have social policy legislation that regulates copyright contracts with various creative contributors to prevent overreaching. These contracts often place restrictions on assignability of royalties or require systems of collective management. For other types of intellectual property, such as patents, compulsory licenses may be allowed, but these are calibrated rules regarding when and how they can be imposed. Similar considerations apply to trademarks.

Outside of these areas, intellectual property law usually accords parties the ability to determine by negotiation the amount and payment of royalties. The practice often differs from that for tangible commodities. When goods are sold, title to the goods typically passes to the buyer. If the parties agree the buyer may pay over time, an income stream or “receivable” arises. Since the seller no longer retains any interest in the goods, it is easy to divorce the receivable from the goods and finance just the receivable alone. This is rarely the case for intellectual property royalties. Instead, they typically represent on-going payments for continued use of the intellectual property. As a result, royalty payments are treated under different international accounting rules and raise different commercial issues when it comes to financing practices.

It is of course possible for a licensor to use royalty payments as a source of collateral. However, it is often the case that a licensor is an intermediate party in the chain of title. That is, a licensor may owe a percentage of the royalty income it collects from its sublicensees to the licensor's own head licensor. As a result, the entire amount of the royalty payments are not necessarily available as collateral; only the net share remaining after paying the head licensor.

In addition, it is can be commercially impractical to separate the responsibilities under a licence from the royalty obligations. A licensor may owe continuing obligations to a licensee which requires use of royalty payments. They can include obligations to develop the intellectual property, to make improvements, to maintain quality controls, to provide marketing material and the like. In such a case, a licensee may require that royalties be directed to specific activities. A secured financing regime must be able to accommodate these commercial considerations.

## **9. Confirm That Intellectual Property Law Applies to Dealings in Tangible Embodiments of Intellectual Property**

Intellectual property is frequently contained in tangible – physical – embodiments. These include pharmaceuticals and mechanical devices that reflect patented inventions; DVDs, paperback books and lithographs that embody copyrighted works; and labels, apparel and merchandise containing trademarks. In these physical embodiments there are in reality two sets of property rights: those in the tangible item; and those in the embodied intellectual property. Intellectual property law nonetheless often limits dealing in tangible embodiments even in the case of one who has possession or even ownership of the tangible item. For example, a person who buys a copy of DVD containing copyrighted music cannot then make and sell thousands of duplicates without permission of the intellectual property owner.

An important concept in this area is “exhaustion.” The idea is that certain conduct with respect to physical embodiments exhausts the ability of an intellectual property rightsholder to control later uses. While there is widespread agreement on the principle, there are often differences in detail regarding the conduct that gives rise to exhaustion and the scope of the rights exhausted. In general terms, an authorized and unconditional sale of a physical embodiment of intellectual property in a country often exhausts the right to control further sales of that same physical embodiment in that same country. However, such a sale does not exhaust other rights, such as a right to control rentals, further adaptations, or other methods of circulation. An open issue in this area is “international exhaustion,” that is, whether an authorized and unconditional sale in County A also exhausts rights in Country B. Generally, it does not.

A related issue is what constitutes a “physical embodiment” in an on-line, electronic world. For example, is an electronic version of a motion picture made available on the Internet a physical copy or an ephemeral performance? Different countries take different views of the matter and the rights involved, especially in the case of copyrighted works. Some countries conceptualize on-line activity as involving aspects of a distribution right, in which case one can roughly speak of downloading as akin to disposition of physical copies and streaming as akin to a performance. Other countries, however, conceptualize the situation as involving a right of reproduction in material form and a separate right representation in immaterial form, leading to different categorizations. The international conventions harmonize the varying approaches by looking to a right of “making available” which can be implemented in different national systems.

These principles also impact a security right in tangible embodiments of intellectual property. For example, assume a security right covers inventory of a debtor which consists of tangible goods made and marketed in a non-electronic setting under a trademark licence. A creditor enforcing its security right in the inventory must still respect the trademark licence. This means the creditor may not be able to resell the goods outside licensed channels as this could impair the value of the brand.

A secured financing regime must deal with physical items which embody intellectual property. It must distinguish physical embodiments of intellectual property from other physical commodities, both in traditional and on-line settings. It needs to address the different property interests involved with respect to creation, effectiveness, priority and enforcement of the security right. A security right that is only effective as to the tangible property right should not apply to the intellectual property right, and *vice versa*.

## **10. Conform to the Choice of Law Rules in Existing Intellectual Property Conventions and National Laws**

Existing intellectual property conventions and treaties establish rules for determining the applicable law based on principles of territoriality, minimum rights and national treatment. These rules are then implemented in national laws. Together they condition intellectual property commerce internationally. A security right in intellectual property assets, if it is to operate effectively, must harmonize with these rules.

In general terms, the intellectual property conventions adopt the principle of territoriality, under which the extent of protection is determined by the law of the protecting country. Under the principle of minimum rights, all member states accord a basic level of protection to intellectual property owners and their successors. Finally, under the principle of national treatment, each member state agrees to treat nationals of another member state no less favorably than it treats its own nationals. This creates a system in which nationals of any one member state know that in any other member state they will be accorded at least certain minimum rights, along with any greater rights that are accorded to locals. The benefits of this structure, including ease of administration and fairness in application, have been proven by experience. The international community has experimented with other systems and found them wanting. This includes a “material reciprocity” or “country of origin” system in which the rights of a person in the home or “origin” state determines the extent of a person’s rights in another member state.

A particular issue in this structure is the proper law for resolving priority disputes between conflicting transfers of intellectual property. This issue is important, because the person with priority can become the owner of the intellectual property or at least obtain sufficient rights to pursue infringers. Thus, priority of transfer often has a direct bearing on protection of rights, which in turn has an impact on the value of assets used as collateral.

As a general matter, each member state can establish its own priority rules consistent with the above principles. Some states use a first in time rule. Other states supplement this rule with a rule that allows a second transfer (to a good faith purchaser for value and without knowledge) to prevail over a prior transfer in proper cases. Different priority rules can apply to assignments and licenses. Since priority can determine entitlement to protection, under the territorial principle, priority is typically determined by the law of the protecting country. A system in which a country must apply the law of another country to determine priority for a transfer made by a non-national may adversely impact minimum rights or national treatment.

### III. CONTRASTING FINANCING MODELS

The primary focus of the draft Legislative Guide is on financing “core commercial assets, such as commercial goods (inventory and equipment) and trade receivables.” Financing structures appropriate for financing this type of asset are not necessarily efficient for intellectual property assets. To the contrary, using a security regime unsuited to the particular assets can reduce the value of the collateral for both the borrower and the lender. The purpose of this section is to provide a high level overview of the different approaches to lending practices for tangible commodities and their associated trade receivables and intellectual property assets and their associated royalty streams.

#### A. Core Commercial Asset Financing

Secured financing regimes that focus on financing core commercial assets often use a structure in which the organizing variables track against the debtor and the debtor’s shifting stock of goods and receivables. An example is working capital financing in which the lender provides cash flow financing for a debtor and takes a floating charge in the debtor’s on-going equipment, inventory and receivables. The idea is that in case of default the secured creditor can take over the going concern value of the business to recover its loan.

Legal rules in this structure often downplay the importance of tracking ownership claims (“title”) in individual items of collateral. Instead, the security right covers broadly defined classes of collateral - goods, inventory, accounts, *etc.* - in transactions that encumber all assets in a class by a single security right that requires minimal monitoring obligations once the initial agreement is struck. Indeed, to facilitate such a system the draft Guide proposes converting any title retention claims in inventory goods into security rights in order to reduce a lender’s due diligence costs. As redefined, these title retention rights must then take their place in the priority line-up with other secured financings. This yields a structure in which the relevant inquiry revolves around the debtor, and so the filing system utilizes a “notice” structure where records are indexed to the debtor rather than individual assets. The filing system does not track prior ownership claims because it eliminates any “chain of title.” It is more concerned with classes of collateral than discrete, and often changeable, items.

We can visualize a typical financing structure following this model as follows:

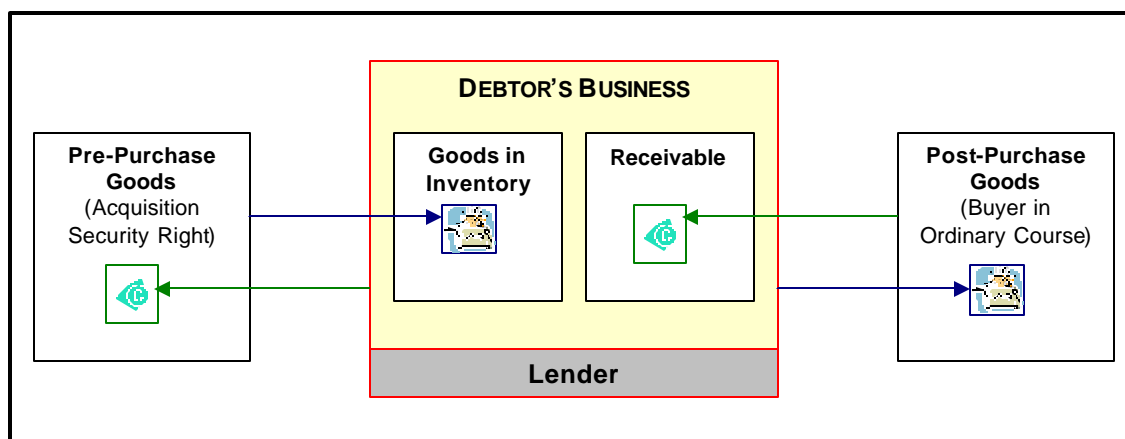


Figure 1: Debtor Based Financing

In this example, although individual items of collateral are sometimes important, by and large what matters is the current stock of the debtor's inventory goods and resulting receivables (or more generally "proceeds") as they change over time. Thus, the Lender takes a floating charge that ranges over classes of assets, as illustrated in Figure 1. Under the priority rules the security right automatically covers inventory as it comes into the debtor's operation, alleviating the need for filing a new collateral description every time that happens. Covering proceeds means the security right remains effective in receivables earned from later sale of inventory. A future assignment clause means a creditor can provide additional cash flow financing while still retaining its earlier priority position. On default, the creditor enforces its rights in the debtor's current assets (inventory and accounts) as they then exist.

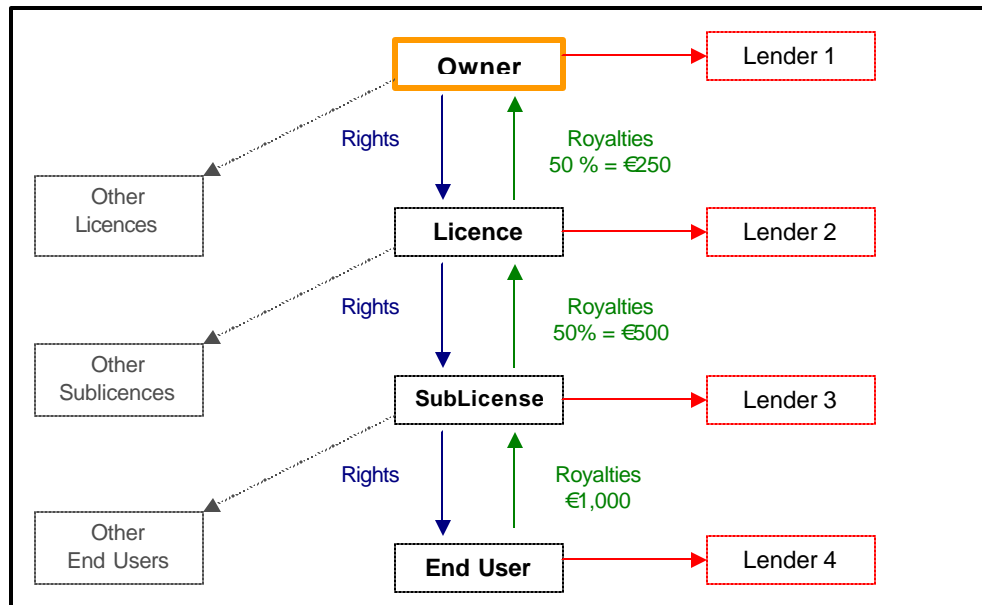
This structure requires mechanisms to deal with collateral before it is owned and after it is sold. The Guide handles these requirements with two "super priority" rules. On the pre-purchase side, a business may want to buy specific machinery, but a financier may be reluctant to extend credit to do so if it knows its security in *that* machinery will become subordinate to a pre-existing floating charge. To solve this problem, the Guide recognizes an "acquisition security right" which can become superior to a pre-existing charge by a timely filing. On the post-sale side, a buyer would not readily purchase goods if the buyer thought a foreclosing creditor of the seller could repossess them. The Guide therefore provides that a "buyer in the ordinary course" can take free of a prior security right against a seller. This system works well for core commercial assets and their related trade receivables. But it does not work everywhere.

## **B. Intellectual Property Asset Financing**

Intellectual property financing primarily utilizes structures in which the organizing variables revolve around specific intellectual property assets and their associated payment streams. In intellectual property law, ownership tracks to creativity, so that rights arise in the person who created the invention or work or first used the mark. Intellectual law then gives the initial rightsholder the ability to control further remote uses, so that asset value arises both in the intellectual property itself and in the array of contractual authorizations to use the intellectual property in various manners, times and places. The ability of the intellectual property rightsholder to make licences which control remote uses in the chain of title is an essential part of intellectual property commerce.

In this structure, since rights associate to the intangible intellectual property, rather than to tangible items, they are not cut-off by transfers to "ordinary course" buyers or licensees. Equally important, many countries establish intellectual property based filing system so that third parties can identify who controls the intellectual property and has authority to file infringement claims or grant licences at each point in the chain of title. This results in a financing system focused on the individual intellectual property assets - patents, copyrights, trademarks, *etc.* In this structure "upstream" rights have ongoing impact on "downstream" rights to use the intellectual property and collect royalties. As a result, the filing systems utilize a recording act in which each particular transfer, indicating the precise interest granted, is recorded in a national filing office and indexed against the particular intellectual property, so that later users can find earlier transfers. All transfers, including security rights, are necessarily included in the same system for ease of searching and consistency of results. This structure supports a context in which development of individual assets often requires substantial investment in those particular assets, with the result that financiers need to obtain security in the particular intellectual property and recoup their investment from the royalty streams arising from *its* exploitation.

We might visualize a typical intellectual property financing structure as follows:



**Figure 2: Intellectual Property Financing Model**

In this example, the intellectual property asset originates with the initial Owner and interests fan out in an array of licences and sublicences. The ability to make multiple licences is illustrated by the gray boxes on the left hand side of the tree. The black boxes illustrate a particular branch of the tree. The sequence of licences from Owner to End User with respect to the intellectual property rights (as opposed to physical copies) is the chain of title to that End User. Each step involves a contract in which a licensor grants rights in exchange for royalties. The rights allow use of the intellectual property in a particular manner, place and time, as illustrated down arrows. The royalties are payment streams illustrated by the up arrows. Sometimes, royalties are a fixed amount. More commonly they are based on a share of the income derived by a licensee from its own sub-licensees due to the difficulty in predicting market acceptance of intellectual property. Thus, in the illustration, End User pays Sub-licensor a fixed royalty of €1,000 for its rights. Sub-licensor in turn owes Licensor a royalty of 50% of its income, and so pays 50% of €1,000 = €500 to Licensor and retains €500 for itself. Licensor in turn owes Owner 50% of Licensor's income, and so pays 50% of €500 = €250 to Owner and retains €250 for itself. These payments are not limited to a single occurrence, but in practice happen continuously over the licence period.

The example also illustrates that at each stage in the chain of title a party may grant security in its rights and royalty entitlements to a Lender. For example, Owner may grant security to Lender 1 in order to obtain the funds needed to create the intellectual property. Lender 1 then looks to the €250 royalty payment from Licensor (along with all other licences) to repay its loan. Licensor may grant security in its rights to Lender 2 to obtain funds to advertise and sub-licence the intellectual property, and Lender 2 in turn looks to royalty payments from Sub-licensor to repay its loan. However, Lender 2 is only fairly allowed, absent a negotiated contrary result, to collateralize Licensor's €250 net share of royalty income, not its €500 gross income. This is because Licensor must pay €250 to Owner (and thus to Lender 1) for continued use of the rights that are generating royalty income in the first place. Otherwise, Owner (or

Lender 1) can terminate Licensor's authorization and Lender 2 will lose its collateral. Of course, Licensor may, and in practice often does, change this result by negotiating with Owner to eliminate termination rights or to treat Owner as an unsecured general creditor, but that requires a voluntary agreement with Owner. Lender 2, however, benefits from this situation because it knows the same result applies to Lender 3, so that Lender 3 cannot take the entire €1,000 payment from End User for itself, but must, absent a contrary agreement with Licensor, remit at least €500 to Licensor to preserve Sub-licensee's rights, thus ensuring Lender 2 that it has a source for repayment of its loan.

This structure creates a cycle in which rights flow "downstream" from initial owners through intermediate licences to end users, and waves of cash – royalties – flow back "upstream" from end users back to initial owners. It is tempting to think that a licensee "owns" the entire royalty wave passing through its coffers at any point in time, but in actuality the licence only surfs on top of the wave to the extent of its royalty share. The remaining portion of royalty income must be passed back "upstream" and on eventually to the initial owner in order to provide remuneration for creative risk and the incentives necessary to make new intellectual property needed for the cycle to continue.

### C. Practical Example of Intellectual Property Financing

It should be apparent that core commercial assets and intellectual property assets can often use conceptually different frameworks to support structurally different types of financing. Stated simply, the intellectual property system best supports a financing framework focused on specific assets or their development, while the core commercial asset system better supports a financing framework that references the going concern value of the debtor's business as a whole. The systems are not interchangeable and, indeed, use of the wrong system for a particular type of asset can impair the interests of both borrowers and lenders.

To understand the issues involved and make the discussion concrete, consider the following hypothetical case:

**Example:** Debtor is in the business of exploiting video rights in motion pictures worldwide. Debtor has obtained exclusive licences from hundreds of producers authorizing Debtor to reproduce and sell videos of their pictures and to grant sublicences authorizing others to do so in multiple countries. In each case Debtor agrees to pay the producer a royalty of 25% of the net income Debtor derives from exploiting the video rights. Debtor has entered into sublicences in 5 countries under which the sublicensees agree to pay Debtor royalties equal to 50% of the sublicensee's income, which Debtor estimates will amount to €100,000 per quarter for the next three years. Debtor approaches Lender about a loan secured by Debtor's video licences and its expected royalty income.

In this situation Lender is taking a security right in Debtor's licences from producers and its resulting royalty payments from sub-licensees. As each picture is unique, Lender should evaluate each one to determine Debtor's rights and expected revenue against which it will extend credit. This process involves two related but distinct issues. The first is the problem of ensuring Debtor has rights in the intellectual property and there are no conflicting *prior* claims that could impair Lender's interest. The second is the problem of establishing the priority of Lender's lien in the Debtor's rights and royalty streams against *subsequent* creditors of Debtor as well as sub-licensees and their creditors.

Start with the issue of evaluating Lender's rights with respect to prior parties. This entails the following steps. First, the Lender needs to search the chain of title for each picture to ensure a valid sequence of transfers from the initial owner, which may or may not be the producer, and onto Debtor. Typically, Debtor itself does this when acquiring each picture; alternatively, Debtor, and Lender, may elect to rely on representations and warranties from a producer. Second, since continued use of intellectual property after licence termination can be infringing, Lender needs to examine each licence for termination rights. This applies throughout the chain of title, since termination of any prior licence, including by foreclosure of a prior lien, terminates all licences deriving from it. Third, the Lender must check each licence from a producer to determine whether it contains anti-assignment language that may restrict the Debtor from using the licensed rights as collateral. Finally, Lender should examine payment obligations under the licences, such as the 25% royalty payable to producers. These payment obligations may thus affect Debtor's effective income available as collateral and also impact the value of the collateral in case of enforcement of the security right.

Once the Lender has completed these steps, the next issue involves ensuring priority over subsequent licensees. This entails the following steps. First, for each licence Lender includes in the borrowing base, Lender should take necessary steps to establish priority against competing claimants of the Debtor. This of course will depend on the applicable priority rule. For exclusive copyright licenses, this can often entail ensuring that the underlying copyright in each motion picture is duly registered, if the licence to the Debtor is duly recorded in an applicable national copyright office, and whether Lender's security right is recorded there as well. Second, Lender may also desire to review and approve the terms under which Debtor makes new sub-licences. This can include terms regarding up-front payment of expected royalties, allowing termination in case of non-payment, restricting assignment of the sub-licence or royalty payments, and the like. These are similar to the provisions Lender examined when it evaluated the licences from the producers. Third, Lender should also take steps needed to ensure priority of its interest against subsequent transferees from Debtor, as well against competing claimants of the sub-licensees. Such priority typically follows from Lender's recording of its security right in Debtor's intellectual property rights. Lender may also give sub-licensees notice that their royalty payments have been assigned to Lender, and Lender and the sub-licensees may enter into agreements under which each sub-licensee acknowledges the assignment to Lender and agrees to make all payments to Lender, whilst Lender agrees not to terminate any sub-licence in case of foreclosure so long as timely payments are made.

This system facilitates efficient financing in three ways. First, it establishes symmetry of obligation. That is, although Lender has the burden in clearing chain of title at the "look up" stage with regard to prior parties, it obtains the benefit of using those rules at the "look down" stage to establish priority over sub-licensees and to create contractual means to obtain payment. Second, the system facilitates valuation of collateral. Each picture Debtor licences will have a different value and expected income stream. Examining chain of title and expected revenue for each picture allows a Lender to determine the proper value to place on each asset it includes in the borrowing base. Third, the system allows adjustment of credit risk by tailored contractual terms. Just as every picture is different, each sub-licensee can have a different credit profile. Debtor, with Lender's oversight, can thus adjust by individual negotiation those contracts that will require termination and non-assignment rights to enforce payment obligations to yield the best credit risk.

## D. Impact of Using Core Commercial Asset Rules for Intellectual Property

It is useful to compare how the Lender in the Example would fare using the financing system for core commercial assets. It is claimed that such a system would allow Lender to encumber all of Debtor's licences in a single security right that covers all pictures as soon as they are licensed. The lien would be publicized by a notice filing against Debtor in the tangible personal property records where the Debtor is located. To give Lender the maximum source for repayment, the system would evidently provide that the producers' claims to their 25% royalty are or should be converted to security rights. As such, to obtain priority over Lender's security right the producers must make a timely filing against Debtor in the local security rights systems where the Debtor is located, not the intellectual property system where the licence is effective. In addition, the financing system would invalidate any legal rule or contract right in the producers' licences that restricts Debtor's ability to assign its rights for security or that allows termination of the licence for granting a security right.

In this vision Lender, by a single notice filing in the local filing system where the Debtor is located, can create an effective security right in all of the Debtor's intellectual property rights as soon as they are licensed and establish priority of the Lender's right to royalty income ahead of prior parties such as producers. Such a result, by easing the ability of the Lender to take security in Debtor's going concern value, would seemingly enhance the extension of low cost secured credit.

In fact, the opposite is true. Under this system, Lender's collateral and Debtor's business would be substantially impaired, and credit costs substantially increased. The problem is that this approach sees Debtor's activities in sub-licensing its rights as divorced from its activities in acquiring the rights, whereas due to intellectual property chain of title, the opposite is the case. As a result, the rules intended to "free up" the Debtor's assets for secured financing *as a licensee* are available to Debtor's sub-licensees and their lenders to reduce Debtor's ability as *a licensor* to collect the income Lender needs to retire the debt. Consider how this would work in practice.

Start with the Lender's problem of ensuring its ability to collect royalty payments from Debtor's sub-licensees. Under the core commercial asset system, these sub-licensees may also have lenders who can use the same rules to limit payments to Debtor just as Debtor used them to limit payments to the producers. For example, assume a sub-licensee has assigned all of its income from which it makes the €100,000 quarterly payments to its own creditor. How does the Lender assure itself it can obtain these payments ahead of the sub-licensee's secured creditor? The same rules that gave the Lender priority over payment claims of the producers would give the sub-licensees' lenders priority over the payment claims of Debtor.

Under the core commercial asset system, Lender was arguably relieved of the burden of searching all of the hundreds of *prior* licences from producers, but now it must instead search the hundreds of *subsequent* sub-licensees to find their lenders. Under the intellectual property system the Lender only needed to make only one filing per picture in an available national system to establish priority against later transferees; now the Lender must make a new filing for each sub-licensee to obtain priority. Under the intellectual property system, to ensure payment Lender could require Debtor to include anti-assignment provisions in each sub-licence prohibiting sub-licensees from assigning their rights to their own creditors, or allowing termination in case of an unauthorized assignment or non-payment. The core commercial asset financing system could undermine this alternative.

If sub-licensees are using the intellectual property without full payment, the Debtor may be forced into default and Lender may need to enforce its security right. When so doing, Lender would at least like to take back the intellectual property rights free of the claims of junior sub-licensees, and re-licence the intellectual property to earn income. Under the priority rules in the intellectual property system, this is exactly what would happen unless the sub-licensees made a separate agreement with Lender. But the priority rules in the core commercial asset system provide that certain “ordinary course” sub-licensees may continue to use intellectual property free of Lender’s security right. As such, Lender may have limited ability to ensure further payment or to re-licence the intellectual property free of existing licences to earn new value.

To address these problems, Lender is now faced with extensive monitoring, searching and filing requirements to ensure that it can recover its loan from the royalty income debtor expects to collect from sub-licensees. The supposed simplicity and economy of the core commercial asset security system has melted away in costly systems needed to ensure the continuing value and enforcement of the intellectual property collateral.

Moreover, reliance on the core commercial asset system could also increase the Lender’s risk of loss due to infringement or fraud. Assume that Debtor proposes to add to the borrowing base a licence for a new motion picture. In fact, Debtor does not own any rights in this picture because of a defect in the chain of title (infringement risk) or the Debtor is simply misstating its rights (fraud risk). The system for tangible assets reduces these risks by background property rules that equate possession with ownership. These rules do not exist for intellectual property. The notice filing against Debtor did not help Lender deal with these risks because the background legal rules for intellectual property had different ownership and vesting rules.

One must also consider the problem of ensuring that Lender can even use the collateral in case it needs to enforce its security right. A security interest has limited value unless on foreclosure a secured creditor can acquire the debtor’s rights in the collateral. This requires a priority rule to resolve claims between a secured creditor who obtains ownership by foreclosure and a bona fide purchaser. Unless the security right filing system entirely replaces the system for tracking ownership transfers, Lender must still file in the intellectual property system to preserve the value of its collateral against competing ownership claims. In other words, use of the core commercial asset filing system alone is of minimal value to Lender.

In sum, use of the financing rules developed for core commercial assets for intellectual property asset financing actually have a negative impact on the collateral value. The rules that “freed up” the intellectual property collateral so the lender’s security right could become effective had the effect of impairing the legal rules that allowed the lender to enforce its rights in case of default. In such a setting, a lender may well desire to deal with legal and contractual restrictions up front before making the loan rather than worrying later about the ability to recover the debt after the money is lent.

## **IV. CONCLUSION**

The primary focus of the draft Legislative Guide is on financing “core commercial assets, such as commercial goods (inventory and equipment) and trade receivables.” As this Report illustrates, financing structures appropriate for this type of asset are not always adequate or efficient when the collateral shifts to intellectual property assets.

As mentioned above, the current draft of the Legislative Guide only contains a narrow definition of “intellectual property.” It then provides an even narrower exclusion of “intellectual property” from the recommendations in the Guide, one which requires member states to conduct an “issue by issue” analysis to uncover any “direct conflict” between the recommendations in the Guide and existing intellectual property law. The Guide, however, provides no reference to the considerable conflicts that can arise when applying its recommendations inappropriately to intellectual property assets, nor does it offer any recommendations for necessary adjustments. This omission is a matter of deep concern, since inappropriate application of recommendations in the Guide to intellectual property assets could lead to inconsistencies with international intellectual property and trade conventions. It is thus important that the Guide adopt a fuller exclusion for all intellectual property assets from its current set of recommendations. The Guide can then develop a studied explanation of the different legal and commercial practices that apply to intellectual property assets, and provide a new and separate set of integrated recommendations for an effective system of intellectual property asset financing.