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WEBINAR FEATURE

Value and Risk Considerations for Intellectual Property Collateral

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Increased technology innovation, content creation, and brand marketing have propelled the value of intellectual property (IP) in the global economy to a historical height. IP is a broad concept that encompasses a variety of intangible assets, including patents, copyrights, trademarks, trade names, domain names, know-how, and trade secrets. With IP's rising importance and value, companies are not only utilizing their IP for revenue generation in the ordinary course of business but also seeking to leverage their IP as collateral to secure funding to support business growth or, in difficult times, maintain liquidity. For example, in the summer of 2020 during the COVID-induced travel slump, United Airlines pledged its MileagePlus frequent flyer program, including important IP assets such as brands and member data, to secure a $5 billion loan.[1]

➪ Attend the corresponding webinar, "Understanding the Intricacies of Using Intellectual Property as Collateral," on July 19, 2022.

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This article presents a brief overview of issues that arise in using IP as collateral, including overlapping federal and state law, the requirements for perfecting security interests in IP collateral, due diligence steps in assessing IP collateral, and considerations in drafting the applicable agreements, including a notable case illustrating how a lender's interests in IP, though perfected, may nevertheless be defeated.

Importance of IP as Collateral

There are several contributing factors to the rise of IP as collateral. First, according to a 2020 study, intangible assets, a majority of which are IP assets, are estimated to account for 90% of the total assets held by companies in the S&P 500.[2] This compares to 32% in 1985 and 68% in 1995.[3] A similar study estimates that, as of 2018, S&P 500 companies held over $21 trillion of intangible assets, compared to only about $4 trillion of tangible assets (e.g., inventory, real estate, and equipment).[4] Thus, it is only natural that both borrowers and lenders are increasingly looking at IP portfolios as a potential source of valuable collateral.

Moreover, for companies that have long-term secured credit facilities or have gone through multiple rounds of secured financings, most tangible assets have already been pledged as collateral, often leaving IP as the only remaining unpledged assets. Further, many companies are continuing to innovate and create new IP, thus increasing the size and value of their IP portfolio, which in turn raises the attractiveness to their lenders of that portfolio as collateral.

Indeed, the increasing popularity of IP as collateral is supported by public data. A review of the U.S. Patent and Trademark Office (USPTO) trademark assignment database reveals an accelerated increase in the number of security agreements recorded against unique trademarks in recent years. The data for patents is similar. In short, IP should always be considered when assessing collateral packages.

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- The Patent Act of 1952 (35 U.S.C. §§ 1 *et seq.*), protecting inventions in many technology areas, including pharmaceuticals, electronics, mechanical inventions, etc.
- The Lanham Act of 1946 (15 U.S.C. §§ 1051 *et seq.*), protecting trademarks and other source identifiers
- The Copyright Act of 1976 (17 U.S.C. §§ 101 *et seq.*), protecting all forms of creative expressions, including software, movies, books, and other media properties
- The Defend Trade Secrets Act of 2016 (18 U.S.C. §§ 1832 *et seq.*), which created a federal cause of action for trade secret misappropriation

Note that state law also applies in certain instances to, for example, the registration of trademarks and trade names and the protection of trade secrets (e.g., state statutes adopting the Uniform Trade Secrets Act). In addition, domain names, rights of publicity, and proprietary know-how that does not qualify as trade secrets are also regularly included in IP collateral packages, even though they are not governed directly by any federal law.

U.C.C. Article 9 and Federal Preemption

In general, secured transactions are governed by Uniform Commercial Code (U.C.C.) Article 9. However, it should be noted that the U.C.C. is a model statute that has been adopted in all 50 states (and D.C.), with each state introducing its own variations to the model version. Thus, it is important to check the specific version adopted by the state whose law will govern a specific transaction. Furthermore, U.C.C. Article 9 does not apply to the extent that it is preempted by federal statute, regulation, or treaty but defers to federal law "only when and to the extent it must."[5] This limited deference is critical to understanding the different requirements for perfecting security interests on different IP assets, as further explained below.

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pledged as collateral,[6] although its rights in the IP need not be ownership rights—licensed rights can also be pledged (subject to contractual limitations). Finally, the debtor must sign or otherwise authenticate a security agreement that reasonably identifies the collateral. This identification of collateral can be drafted broadly.[7] For example, language such as "all patents," "all copyrights," or even "all intellectual property" of the debtor could be sufficient.[8] In addition, the identification of collateral can also include after-acquired IP.[9]

Perfection of a Security Interest in IP

To obtain priority over others, including a trustee in bankruptcy, the security interest must be perfected. Perfection is the process that allows a secured creditor to potentially acquire priority in respect of pledged collateral over other parties who also have an interest in the collateral pledged by the debtor.

U.C.C. Article 9 classifies properties pledged as collateral into different categories, with IP falling within the "general intangibles" bucket.[10] As a general rule, the secured party perfects its security interest in most kinds of collateral, including general intangibles, by filing a U.C.C. financing statement (i.e., UCC-1 statement) "indicating" the collateral in the appropriate filing office in the applicable state or other jurisdiction as per Article 9.[11] This "indication" of collateral need not be specific, although if it does not cover all assets, it must, like a security agreement, "reasonably identify" the collateral.[12] Further, the filing is to be made where the debtor is "located," which for most U.S. entity debtors is the jurisdiction of formation or organization of the debtor.

However, as noted above, when IP assets are pledged as collateral, several federal statutes are potentially implicated. The critical issue becomes how the federal preemption rules affect the general method of perfection (i.e., perfecting by filing a UCC-1 financing statement) when the security interest covers IP. Although U.C.C. Article 9 contains a general rule that filing a UCC-1 financing statement is not necessary or effective to perfect a security interest in property subject

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security interests in those assets must be perfected by filing a UCC-1 financing statement.[14] Nevertheless, many secured parties with liens on patents and/or trademarks also record their security interests with the USPTO[15] to help put third parties on notice that a security interest exists against such assets.

Registered copyrights are situated differently. The Copyright Act, unlike the Lanham Act and the Patent Act, discusses recordation of "transfer of copyright ownership,"[16] which is a term explicitly defined to include "mortgage."[17] In the context of the Copyright Act, "mortgage" has been interpreted to be equivalent to "security interest."[18] As a result, federal copyright law preempts U.C.C. Article 9, and the secured party should perfect its security interest in *registered* copyrights by filing a document detailing the security interest with the U.S. Copyright Office.[19] Notably, a UCC-1 financing statement is still necessary to perfect a security interest in *unregistered* copyrights.[20] Nevertheless, most secured parties will also file a UCC-1 financing statement to perfect a lien in a registered copyright, the reason being, again, to better put others on notice of their security interest.

The chart summarizes the perfecting methods for different types of IP. Because debtors often pledge multiple types of IP as a collateral package, a single UCC-1 statement also commonly references all IP in the package. The *recommended practice* of perfecting a security interest in IP is to (1) file a UCC-1 financing statement with the secretary of state's office in the jurisdiction where the debtor is located, *and* (2) as applicable, record the security interest with the USPTO and/or the Copyright Office.

	FEDERAL LAW PREEMPTS U.C.C. ARTICLE 9?	FINANCING STATEMENT (UCC-1)

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COPYRIGHTS (REGISTERED)	Yes	Recommended
COPYRIGHTS (UNREGISTERED)	No	Must File
TRADE SECRETS	No	Must File

General Rules of Priority under U.C.C. Article 9

Under U.C.C. Article 9, the priority of secured creditors is generally based on the first-to-file-or-perfect (FTFOP) rules. In short, barring certain exceptions, the first secured party to file or perfect its rights related to the collateral will have priority over competing security interests held by other parties.[21] The following common scenarios illustrate the general operation of the FTFOP rules:

- When no party perfects, the first party to have an attached security interest has priority. Thus, an unperfected security interest in IP has priority over (1) other unperfected security interests that attach later in time and (2) any unsecured claim against the debtor.
- When more than one party has an attached security interest, but only one party perfects, the perfecting party has priority over the other creditors. Thus, a perfected security interest in IP has priority over any unperfected security interest in such assets.

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- Purchase money financing—i.e., financing to a debtor to enable it to purchase certain property—is favored under the U.C.C. and, subject to certain notifications by the creditor providing such financing, can give such creditor priority over an earlier perfected security interest.[22]

- Under certain circumstances, third parties acquiring collateral subject to an existing security interest, including a buyer of goods in the ordinary course of business and a "licensee in the ordinary course of business," may take the collateral free of a prior perfected security interest.[23]

Due Diligence Considerations for IP Collateral

Common Risk Factors of IP Collateral

In conducting due diligence on IP collateral, lenders want to confirm that such assets have value, are properly protected (and, where applicable, registered), are marketable, and can be monetized in the event of a default. Common risks associated with using IP as collateral include:

- IP rights can be lost for various reasons, for example: (1) issued patents and registered trademarks can be invalidated or canceled by competitors or other third parties; (2) fraud on the USPTO during the prosecution or procurement process could cause IP rights to be unenforceable or invalid; (3) the debtor could, wittingly or unwittingly, abandon the IP by failing to prosecute or failing to maintain the rights or registrations; or (4) the debtor could, intentionally or involuntarily, disclose trade secrets or other valuable proprietary information (e.g., source code) that should be kept in confidence.

- The debtor could harm the IP's value by licensing or otherwise encumbering the IP without the lender's knowledge.

- The debtor could cause leakage of assets by transferring some or all of the IP assets out of the

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In view of the risks of accepting IP as collateral, lenders should take specific steps during the diligence process to assess the value and risk profile of the IP assets. A nonexhaustive list of diligence items includes:

1. Conduct domestic and international owner-based searches (in combination with requesting written disclosure from the debtor) to determine how much registered IP is available. Such searches should be inclusive of all databases, e.g., USPTO (patents, trademarks, applications), Copyright Office, WIPO, and WhoIs (domain names).

2. Inquire as to what material nonregistered IP (e.g., trade secrets, unregistered proprietary software) is owned by the debtor and available as collateral. If there are material trade secrets or proprietary know-how, then inquire as to the debtor's policies, procedures, and nondisclosure/confidentiality agreements protecting such confidential information. If there is proprietary software, then inquire as to any source code escrow agreement or open source license that might require disclosure of the source code to third parties.

3. Inquire as to what licensed IP is held by the debtor and potentially available as collateral. Are the licenses transferrable? Are there any restrictions on the debtor's right to use or exploit such licensed IP?

4. Verify ownership and encumbrances of the identified IP assets. Who is the owner of record of each piece of the identified IP assets? Are there any chain of title issues?[25] Are there any challenges to the ownership or claims of competing or superior interest? Are any of the IP assets already subject to security interests? Are any of the IP assets subject to any license or assignment obligations?

5. Inquire as to any infringement of the IP assets by third parties or infringement of third-party IP by the debtor.

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8. When necessary, the lender should seek expert advice for valuation of the IP assets.

It is not uncommon for the debtor to conduct a preliminary review of its IP assets following the same steps above to anticipate and proactively address any potential issues that might arise during the lender's diligence process. In addition, having a clear grasp of its own IP portfolio helps the debtor to evaluate what and how many IP assets to include in the collateral package.

Key Issues in Drafting the Finance Agreement

Generally, the lender would want to define IP broadly to be all-inclusive of registered, pending, unregistered, and future IP. For example:

- "Patents" would be defined to include (1) pending applications, issued patents, continuations, continuations-in-part, divisionals, substitutes, reissues or reexaminations, foreign equivalents, and improvements; and (2) any later-filed applications that are related or claim priority to any of the foregoing.
- "Trademarks" would encompass (1) trademark registrations, applications, service marks, unregistered marks, trade dress, logos, designs, fictitious business names, and any business identifiers; and (2) any "goodwill of the business" associated with any of the foregoing.
- "Copyrights" would cover both registered and unregistered copyrights.
- "Trade secrets" and "know-how" would include all confidential and proprietary business and/or technical information.

Further, the lender would want to address situations where the IP is challenged or deemed infringing or invalid, for example, by requiring the debtor to supply additional collateral. Moreover, as explained further below, the lender should also evaluate the risk of J.Crew trap doors

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such a pledge jeopardizes the underlying applications. Finally, the debtor should also make sure that the lender's rights in respect of the IP collateral are not drafted so broadly as to interfere with the debtor's ability to use such IP in its daily operations.

IP Representations and Warranties

To the extent possible, the lender would also want to get comprehensive representations and warranties from the debtor about the IP collateral, including:

1. the debtor is the proper owner of or has valid license rights to each piece of its IP assets;
2. there is no gap in the chain of title and the debtor has received proper assignment of IP from employees or contractors;
3. there are no actual or threatened challenges to the debtor's ownership or license rights;
4. the IP assets owned by the debtor are subsisting, valid, and enforceable;
5. the debtor is in compliance with the IP licenses received from third parties;
6. the debtor has used commercially reasonable efforts to protect its confidential and proprietary information, including trade secrets and know-how;
7. the IP owned by the debtor does not and has not infringed or otherwise violated the IP of any third party, and the debtor has not received any notice of infringement from any third party;
8. the IP owned by the debtor is not and has not been infringed or otherwise violated by any third party, and there is no contemplated, threatened, or pending litigation against any third party; and

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Committee, with the goal of bridging the gap between U.C.C. and IP lawyers by offering and, more importantly, explaining the provisions lawyers should consider in an IP security agreement. The MIPSA assumes, and is intended to work with, a separate loan agreement that will contain the more general terms relating to the secured obligations.

It should be noted that, unlike certain other model agreements promulgated by ABA groups, the MIPSA does not purport to be a fully negotiated agreement reflecting the interests of both debtor and secured party. The task force confirmed that while some model agreement provisions can be used with only minimal changes, IP assets are so varied that a one-size-fits-all approach would not work.[27] Accordingly, the MIPSA is presented as a "teaching tool," with over 80 explanatory footnotes containing suggested alternative approaches to commonly negotiated provisions. Nevertheless, the provisions of the MIPSA itself are clearly lender favorable. For example, the representations, warranties, and covenants are presented generally without qualification or limitation.

Other notable aspects of the MIPSA include:

- Simplification of the security interest creation language, avoiding phrases such as "assign, transfer, pledge, hypothecate," the concern being that at least under patent and trademark laws, assignment language suggests transfer of ownership to the lender
- Adoption of broad and comprehensive granting language intended to cover all types of IP; the granting language also includes present and future rights and interest in the various forms of IP, and further includes (and requires itemization of) foreign intellectual property but does not provide for the protection or enforcement of that lien under foreign law
- Inclusion of a "savings" clause, typical in many security agreements, in the case of IP licenses—namely, that if there exists law or a contract that prohibits the grant of a security interest in

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In 2017, J.Crew made headlines for its approach to refinancing certain soon-to-mature debt. Challenging business circumstances forced J.Crew to look long and hard to find value in the company to secure indebtedness when substantially all existing assets, including IP, were already pledged as collateral for over $1.5 billion in term loans. Eventually, J.Crew carried out some then novel maneuvers to transfer the vast majority of its IP (including its well-recognized trademarks) outside the existing collateral structure to an unrestricted subsidiary and then have the unrestricted subsidiary use such IP to secure newly incurred indebtedness. These steps were referred to as the "J.Crew trap doors."

To better understand the J.Crew trap doors, it is important to note the following definitions and roles:

- "Loan parties," which are the debtors in respect of the original collateral (including IP) and are subject to the restrictive covenants of the original loan agreement
- "Restricted subsidiaries," which are *not* loan parties or guarantors of the original loans but *are* subject to the restrictive covenants of the original loan agreement
- "Unrestricted subsidiaries," which are *not* loan parties or guarantors of the original loans and are *not* subject to the restrictive covenants of the original loan agreement

The loan agreement prohibited certain investments by the loan parties and their restricted subsidiaries. There were exceptions to that prohibition in the form of permitted investment baskets. Those baskets were as follows:

A. a general permitted investment basket, which allows investments made by loan parties in any party capped by the greater of $100 million or 3.25% of total assets, plus an additional amount based on earnings;

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The combination of using baskets B and C above is commonly referred to as a "trap door.

So how exactly did J.Crew move some of its most valuable IP out of its existing collateral package, freeing up that collateral to secure additional financing? It involved a two-step process. First, under baskets A and B above, J.Crew transferred over 70% interest in its IP assets (including trademarks) that were part of the collateral package securing its existing $1.5 billion term loan to a restricted subsidiary named J. Crew Cayman. The transferred IP was valued at $250 million, equaling the combined cap of baskets A and B. Next, taking advantage of basket C, restricted subsidiary J. Crew Cayman then transferred the IP to J. Crew Brand Holdings, LLC, an unrestricted subsidiary, which was not subject to the terms of the original term loan facility and free to incur additional indebtedness secured by such IP. Indeed, the unrestricted subsidiary went ahead to secure additional loans using the transferred IP as collateral without having to worry about the security interest held by J.Crew's $1.5 billion term loan lenders. In addition, the unrestricted subsidiary then licensed the IP back to the loan parties such that the loan parties would have to pay royalties to use the trademarks they once owned just to continue daily operations.

Since J.Crew, many other parties followed suit and successfully exploited similar provisions in their preexisting credit facilities, which prompted the lenders to devise blockers to mitigate the trap door risk in subsequent transactions. Commonly included blockers are:

- restrictions on the transfer of material or "crown jewel" IP;
- restrictions on investments in or by non-loan party restricted subsidiaries; and
- restrictions on investments in unrestricted subsidiaries.

Final Takeaways

First, IP is an important asset class for almost all companies, and for many companies it is the

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Furthermore, comprehensive IP diligence needs to be a standard operating procedure for lenders in view of the various risk factors associated with accepting IP as collateral.

Finally, the lender should carefully consider whether the debtor has the ability to frustrate the lender by moving IP assets out of the collateral package without consent (i.e., J.Crew trap doors).

Endnotes

1. United Airlines Holdings, Inc., Current Report (Form 8-K) (June 12, 2020), https://ir.united.com/node/23771/html; *see also* Tracy Rucinski, *United Airlines Pledges Loyalty Program for $5 Billion Loan*, Reuters (June 15, 2020), https://www.reuters.com/article/us-health-coronavirus-united-arlns/united-airlines-pledges-loyalty-program-for-5-billion-loan-idUSKBN23M1PB.

2. *Intangible Asset Market Value Study*, Ocean Tomo (2020), https://www.oceantomo.com/intangible-asset-market-value-study.

3. *Id.*

4. Ponemon Inst. LLC, 2019 Intangible Assets Financial Statement Impact Comparison Report (2019), https://www.aon.com/getmedia/60fbb49a-c7a5-4027-ba98-0553b29dc89f/Ponemon-Report-V24.aspx.

5. U.C.C. § 9-109(c)(1) and cmt. 8; *see also id.* § 9-311 (covering federal preemption regarding methods of perfection).

6. *See, e.g.*, *In re* Franchise Pictures LLC, 389 B.R. 131, 143 (Bankr. C.D. Cal. 2008) ("Since [the defendant] had no interest in the collateral, the Copyright Mortgages did not and do not encumber any property of the [defendant's] Estates.")

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10. *Id.* § 9-102.

11. *Id.* §§ 9-310(a), -501, -502(a).

12. *Id.* § 9-504.

13. *Id.* § 9-311(a)(1).

14. *See, e.g.*, Cathay Bank v. Gryphon Mobile Elecs., LLC, No. 2:21-cv-03909-SB-JEM, 2021 U.S. Dist. LEXIS 190237, at *3–4 (C.D. Cal. June 28, 2021) ("[F]ederal law does not apply to a dispute concerning a security interest simply because the interest is in a patent." (citing *In re* Cybernetic Servs., Inc., 252 F.3d 1039, 1057–59 (9th Cir. 2001) (concluding that "'the Patent Act does not cover security interests or lien creditors at all' and that a security interest in a patent was perfected upon compliance with California filing requirements, despite lack of recording of interest with PTO"))); Trimarchi v. Together Dev. Corp., 255 B.R. 606, 612 (Bankr. D. Mass. 2000) ("[T]he Lanham Act's registration provision does not preempt U.C.C. filing requirements for the perfection of a security interest in a trademark.").

15. *See* 35 U.S.C. § 261; 15 U.S.C. § 1060.

16. 17 U.S.C. § 205.

17. *Id.* § 101.

18. *In re* World Auxiliary Power Co., 303 F.3d 1120, 1126 (9th Cir. 2002) ("The Copyright Act's use of the word 'mortgage' as one definition of a 'transfer' is properly read to include security interests under Article 9 of the Uniform Commercial Code." (footnote omitted)).

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preempt the California U.C.C. as to unregistered works, and (2) the bank properly filed a UCC-1 financing statement).

21. U.C.C. §§ 9-317, -322.

22. *Id.* § 9-324.

23. *Id.* §§ 9-320, -321.

24. From the debtor's perspective, a major concern with granting the lender too broad a right to the IP collateral is that it might deprive or materially interfere with the debtor's ability to use the IP in its ordinary course of business. This point is illustrated in a line of cases involving several Uniloc entities, which have a business model of acquiring patents and suing companies for infringement of those patents. To fund its extensive litigation activities, Uniloc obtained a loan from Fortress Credit Co. LLC secured by Uniloc's patents. Fortress received the right to sublicense the patents following an event of default in its "sole and absolute discretion," although it agreed not to "use" the license unless and until an event of default occurred. In 2017, Fortress's right to use the license was triggered because Uniloc failed to meet the target revenue of $20 million. In 2020, the defendants sued by Uniloc entities challenged Uniloc's standing to sue on the patents subject to the Fortress agreement, and three federal judges agreed, finding that the Uniloc entities lacked standing because they did not possess the exclusive rights to the patents in view of Fortress's broad rights triggered by the default. *See* Uniloc USA, Inc. v. Apple, Inc., No. C 18-00358 WHA, 2020 U.S. Dist. LEXIS 228257, at *19–24 (N.D. Cal. Dec. 4, 2020); Uniloc 2017 LLC v. Google LLC, 508 F. Supp. 3d 556, 572–75 (N.D. Cal. 2020); Uniloc USA, Inc. v. Motorola Mobility, LLC, No. 17-1658-CFC, 2020 U.S. Dist. LEXIS 244512, at *19–25 (D. Del. Dec. 30, 2020).

25. *See, e.g.*, Mayfair Wireless LLC v. Celico P'ship, No. 11-772-SLR-SRF, 2013 U.S. Dist. LEXIS 124206, at *28–34 (D. Del. Aug. 30, 2013) (holding that a gap in the chain of title exists when there is no

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27. *Id.*

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