18 Study on Governing Law on Security Rights in Intellectual Property [*]

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This study looks into the issue of which law to apply to security rights in intellectual property—a field where currently there is no established private international law—, based on the United Nations Commission on International Trade Law's (UNCITRAL) 2010 publication "UNCITRAL Legislative Guide on Secured Transactions: Supplement on Security Rights in Intellectual Property" (hereinafter referred to as the "IP Supplement"). This publication raises doubts about governing international aspects of security rights in intellectual property in accordance with the principle of territoriality—the basis of the existing intellectual property law; and it tries to find a solution in the approach of using the law of the State of the debtor's location, as applicable to security rights in movable assets and receivables (this approach has been developed in the United States and has been rapidly gaining wider support in recent years). This study examines the conflict-of-laws rules suggested by the IP Supplement from the perspective of whether these rules should be introduced in Japan in policy terms, thereby exploring an international law that will be vital to effectively promoting intellectual property finance.

I Introduction

This study looks into the issue of which law to apply to security rights in intellectual property—a field where currently there is no established private international law—, based on the United Nations Commission on International Trade Law's (UNCITRAL) 2010 publication "UNCITRAL Legislative Guide on Secured Transactions: Supplement on Security Rights in Intellectual Property" (hereinafter referred to as the "IP Supplement"). This publication raises doubts about governing international aspects of security rights in intellectual property in accordance with the principle of territoriality—the basis of the existing intellectual property law; and it tries to find a solution in the approach of using the law of the State of the debtor's location, as applicable to security rights in movable assets and receivables (this approach has been developed in the United States and has been rapidly gaining wider support in recent years). This study examines the conflict-of-laws rules suggested by the IP Supplement from the perspective of whether these rules should be introduced in Japan in policy terms, thereby exploring an international law that will be vital to effectively promoting intellectual property finance.

Financing secured by intellectual property is still in the process of developing not only in Japan but also throughout the world. Under these circumstances, before discussing which law to apply to security rights in intellectual property, it is necessary to focus on designing a substantive secured transactions law. In fact, the concern of the IP Supplement is largely concentrated on providing guidelines for the development of law on a national level. At the same time, the IP Supplement presents vigorous debates on the legal policy of promoting intellectual property finance on both the national and international levels. Accordingly, this study does not discuss national issues and international issues of security rights in intellectual property separately but proceeds to discuss them while placing both issues on the same level, aiming to demonstrate, even partially, what law can do to promote intellectual property financing transactions.

The composition of the report is as follows. Chapter II gives an overview of the current situation in intellectual property finance in Japan and identifies legal challenges that hinder the promotion of intellectual property financing transactions. Chapter III reviews how the IP Supplement tries to overcome these challenges. Chapter IV extends the focus to an international level and considers which law should be applicable to security rights in intellectual property, while taking into account the discussion

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presented in the IP Supplement. Chapter V provides policy implications obtained through these discussions.

Ⅱ Limits of the Existing Systems Relating to Security Rights in Intellectual Property

This chapter gives an overview of and identifies problems with the existing systems related to security rights in intellectual property, which are the legal basis for intellectual property finance.

1 Pledge vs. Transfer of Title for Security Purposes

The systems usually employed when conducting transactions secured by intellectual property are a pledge and a transfer of title for security purposes. A pledge is created on intellectual property in favor of the secured creditor, with the intellectual property remaining to be owned by the debtor; and a transfer of title of the intellectual property to the secured creditor for security purposes is registered, and the creditor, in form, becomes the owner of the intellectual property. This difference brings about the following advantages and disadvantages in terms of the respective security rights in different phases.

In the phase of creation and registration of a security right, a pledge, which is categorized as a statutory security right, has a disadvantage in that it cannot be created for a "right to obtain a patent." It has also been said that a pledge is more costly due to a difference in the calculation method of registration costs.[1] On the other hand, a pledge has an advantage in that when several intellectual property rights are encumbered and registered to secure a receivable, these rights are treated collectively and registration fees are calculated only for a single registration as long as applications for registration are filed simultaneously.[2] Another reason for the preference of a pledge is that if the secured creditor has sold an encumbered intellectual property right to a third party, the debtor cannot assert its ownership of the encumbered right against the purchaser, and therefore the debtor would feel a greater resistance to a transfer of title for security purposes.[3]

Looking at the phase of management of a security right, the use of a transfer of title for security purposes can save monitoring costs that may be incurred in this phase because the information relating to an encumbered intellectual property right, such as an invalidation trial, infringement or licensing, is addressed directly to the secured creditor who is the formal owner of the encumbered right.[4] However, there has been criticism that the use of a transfer of title for security purposes would weaken the basis of the right to license.[5] Furthermore, in cases where an encumbered intellectual property right is infringed, since the right to claim an injunction against the infringer is vested in the secured creditor (e.g., the bank) within the framework of a transfer of title for security purposes, concerns remain about whether and to what extent priority to the debtor's business would be assured.[6]

In the phase of the enforcement of a security right, foreclosure is possible both for a pledge and a transfer of title for security purposes if the secured creditor is liable for liquidation. However, in the case of a pledge, since it is impossible for the secured creditor or the purchaser to register a transfer of title of the encumbered intellectual property independently, they would have to go through a cumbersome procedure of filing a lawsuit against the grantor that has created the security right if it is not cooperative.[7] A pledge and a transfer of title for security purposes are chosen depending on circumstances of individual transactions and while taking into account the advantages and disadvantages of the respective security rights summarized above.

2 Transaction Model

A pledge and a transfer of title for security purposes have the following features in common. First of all, both of these security rights enable the debtor to continue to use the encumbered intellectual property after a security right has been created in it.8 This in turn enables the secured creditor to receive repayment of principal and interest from the profit that the debtor earns by using the encumbered intellectual property. Secondly, the effect of both security rights created in intellectual property extends to royalties arising therefrom.[9] Thirdly, both security rights must be registered for each encumbered intellectual property right, which means that it is necessary to identify the asset subject to the security right upon registration.

Intellectual property-based loans can be arranged by applying these features. In this loan transaction, the creditor, upon providing a loan for

the debtor, acquires a security right created in the intellectual property owned by the debtor. The debtor operates business using the loan money; and if the business turns profitable, the debtor repays the loan principal and interest from the profit. If the business fails, the secured creditor enforces the security right in the intellectual property and collects the loan claim from the money obtained by converting the encumbered intellectual property. The Development Bank of Japan has been proactively attempting to arrange this loan scheme since 1995, while requiring companies with poor creditworthiness to create security rights in all intellectual property rights that they own for their technologies and products.[10]

3 Defining the Problem

This section discusses expectations for and realities of intellectual property-based loans. First of all, this loan scheme is expected to serve as an effective means of raising funds available to venture companies and new businesses that have no or only limited tangible assets.[11] Secondly, it enables the founders of venture companies to maintain the controlling interest in their companies.[12] Thirdly, banks are keenly aware of the necessity to shift away from the loans based on the collateral value of immovable property along with the collapse of the myth that land prices will never fall but continue to rise, and under such circumstances, intellectual property-based loans could be an alternative loan scheme.[13] The first and second factors relate to the debtor's situation, and the last one relates to the creditor's situation. This suggests that both debtors and creditors have expectations toward this loan scheme. But have these expectations been reflected in actual loan transactions? The records of loans actually provided by the Development Bank of Japan and private financial institutions clearly show that this loan scheme has not been used very frequently. Thus, there is a large gap between the expectations and the realities in relation to intellectual property-based loans.

What is it that creates such a gap? Although the law for using intellectual property as security is modeled on the law for using immovable property as security, immovable property and intellectual property completely differ in nature. The major characteristics of intellectual property include (1) difficulty to assess the value, (2) instability in rights and value, (3) mutual dependence (with the business), and (4) difficulty to sell or otherwise dispose of.[14] None of these characteristics apply to immovable property. For this reason, intellectual property cannot be regarded as suitable collateral in the same way as immovable property. Thus, with regard to a security right in intellectual property, there is a mismatch between the characteristics of the asset subject to a security right and the secured transactions law, and this may be the cause of the problem.

In order to solve this problem, a scheme to use an intellectual property package or business as security for loans has been undertaken, while taking advantage of the third characteristic of intellectual property mentioned above.[15] In practical terms, efforts have been made to find a solution by making a change in concept from asset-based finance to business-based finance.16 With this approach, however, the necessity to identify the asset subject to a security right under the existing intellectual property law would increase transaction costs. Hence, it follows that a law that can indirectly support the trends toward intellectual property-centric business finance should be designed to meet the demand for a large amount of long-term funds that will not be available through the unsecured loan scheme.

Ⅲ Initiatives by UNCITRAL

As shown above, intellectual property finance cannot be invigorated without a substantive law that enables business-based security. The best material for discussing this issue was provided by UNCITRAL in 2007: the UNCITRAL Legislative Guide on Secured Transactions (hereinafter referred to as the "Guide" or "G").[17]

1 The Outline of the Guide and the Features of the Recommendations

The Guide consists of 12 chapters and two annexes, each chapter comprising general remarks and recommendations (554 pages in total). The purpose of the Guide is to assist States in developing modern secured transactions laws. Unlike a treaty or convention, the Guide does not have any binding force on States; in this respect, it is only a reference book.

The Guide is greatly influenced by Article 9 of the United States Uniform Commercial Code (UCC). The overall picture of a secured transactions law recommended in the Guide can

be understood by referring to its four characteristics. First of all, the Guide adopts a functional approach under which a security right arises from any transaction that can in effect provide security, regardless of the legal form of the transaction (G, rec. 5, 8). A "security right" mentioned here covers all rights created by agreement in any property other than immovable property, including rights under retention-of-title agreement and financial leases (G, rec. 8). This approach rules out the existence of more than one legal form, such as a pledge and a transfer of title for security purposes, and provides a competitive credit facility under a single secured transactions law.

Secondly, under the recommended law, a security right may encumber all assets of the debtor, regardless of type of assets, including not only assets that the debtor presently owns but also those that the debtor will acquire in the future (G, rec. 17). This legal design would be effective with the use of a general security rights registry to be prepared by States. The Guide regards the registration in this registry as the most common requirement for achieving third-party effectiveness, and conceives of a completely computerized registry (G, rec. 32). This registry is to be compiled according to debtor, not according to encumbered asset. There are only three matters required to be stated in the registry: (1) the identification information of the grantor and the secured creditor, (2) the description of the encumbered asset and (3) the duration of the registration. A specific item-by-item description of the encumbered asset is not required (G, rec. 57, Chap. IV, para. 83). Therefore, even a description of "all present and future movable assets" is acceptable (G, Chap. IV., para. 83). Thus, the Guide aims for the all-inclusive use of assets for financing purposes, and requires that any exceptions to these rules should be limited and described in the law in a clear and specific way (G, rec. 17). In short, as compared to the existing law in Japan, the principles and exceptions concerning encumbered assets are reversed under the law recommended in the Guide.

Thirdly, under the recommended law, any future loans may be secured by a security right (G, rec. 16). A security right needs not to have been created before the registration in the general security rights registry (G, rec. 33). It is up to each State to determine whether to require upon registration an indication of the maximum monetary amount to be covered by a security right (G, rec. 57 (d)). In the case of a State that does not require such indication, if a security right is registered in the general security rights registry in advance, it is possible to grasp all assets of the debtor as security for subsequent loans. Thus, the Guide greatly relaxes the requirement to identify the claim secured by a security right as well as the asset subject to a security right.

The fourth feature is the weight attached on the principle of party autonomy. This is particularly noticeable at the enforcement phase. The Guide positively allows a secured creditor to sell or otherwise dispose of, or license an encumbered asset out of court (G, rec. 148), and presents a set of procedural rules for this purpose.

2 IP Supplement

In 2010, in order to include intellectual property in the general security right system under the Guide, UNCITRAL published the IP Supplement (hereinafter also referred to as "S"). [18] The IP Supplement has the same composition as the Guide, consisting of 12 chapters and two annexes (168 pages in total). The overall objective of this publication is to facilitate financing by intellectual property owners and reducing credit costs (S, para. 1).

The secured transactions law suggested in the IP Supplement is designed on condition that it shall not intervene in the basic rules of law related to intellectual property (G, rec. 4 (b)). The IP Supplement has been drafted by explaining how the Guide would be applied in the context of intellectual property and making recommendations on some matters specific to security rights in intellectual property (S. para. 4). This approach is most clearly embodied in the explanation of the scope of application of the Guide. That is, the Guide does not address the vertical relationships in Figure 1 (transfer or licensing), which should be governed by the law related to intellectual property.

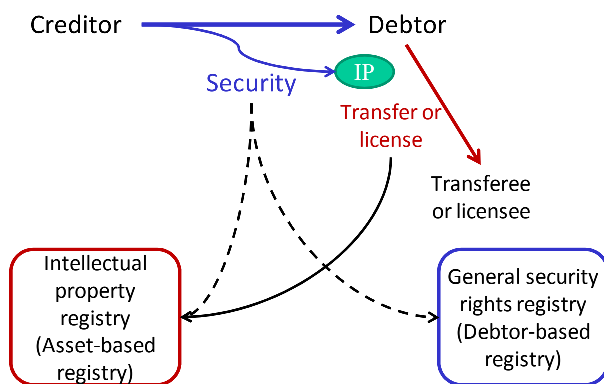

Figure 1 Dual Sources of Right Information

Let us look at the sharing of roles between the intellectual property registry and the general security rights registry. The Guide allows a security right to be made effective against third parties by its registration in a specialized registry for the encumbered asset, as an alternative to the registration in the general security rights registry if such specialized registry has already been compiled (G, rec. 34 (a) (iii), 38 (a)). Accordingly, if a State chooses to have the intellectual property registry continue to serve as public disclosure of a security right, this would result in the co-existence of two registries on security rights in the same intellectual property. As for the order of priority between these registries, there is a rule that a security right in the intellectual property registered in the asset-based intellectual property registry has priority over a security right in the same intellectual property registered in the debtor/creditor-based general security rights registry (G, rec. 77 (a), and S, para. 138). What kind of rule should apply where the vertical relationships and the horizontal relationships cross each other?[19] A possible problem that may occur in such a case is whether the secured creditor is entitled to make its security right effective against the transferee of the encumbered asset. The IP Supplement solves this problem by providing that if a security right has not been registered in the intellectual property registry, the secured creditor is not entitled to make its security right effective against the transferee or any other competing claimant in vertical relationships (G, rec. 78, and S, para. 138).

In short, a secured creditor cannot make its security right effective against all competing claimants merely by registration in the general security rights registry. Therefore, in order for the secured creditor to perfect its security right, it might have to publicly disclose its security right by way of the intellectual property registry. However, if the debtor is prohibited under a loan agreement from exercising its own discretion in concluding a licensing agreement or creating a security right in the encumbered intellectual property, the secured creditor would be able to strengthen the effectiveness of its security right that is publicly disclosed in the general security rights registry to a considerable extent.

3 Transactions in Accordance with the Guide and the IP Supplement, and the Significance Thereof

This section attempts to conceive of a structure for an intellectual property-based loan scheme that can be arranged in accordance with the Guide and the IP Supplement as described above. Unlike the transaction discussed in II-2 above, in the transaction under this loan scheme, it is possible to secure the business as a whole. In other words, it is possible to stretch a net of security over multiple assets involved in the business, including intellectual property rights, production equipment, accounts receivable and inventory. According to the Guide, since a security right in an encumbered asset extends to its proceeds, royalties arising from the encumbered intellectual property before being mixed with other assets can be covered by this net of security (G, rec. 19). If such a security right is registered in the general security rights registry, the secured creditor may be entitled to make its security right effective against third parties. This relaxation of the requirement to identify the asset subject to a security right and the claim secured by a security right would, under substantive law and at low costs, result in enabling the secured creditor in the first rank to automatically acquire the right to receive payment in preference to others for subsequent loans from the total assets covered by the net of security.[20]

The function of such an all-inclusive or general security right can be explained as follows. Under ordinary conditions, the secured creditor can increase the monitoring of the debtor's business, thereby preventing the debtor's default, which may be caused by factors other than the business, and reducing the default rate. In an emergency, it would be possible for the secured creditor to prevent the dispersion of the debtor's assets that are necessary for business rehabilitation and carry out the rehabilitation plan under the secured creditor's initiative.[21] This

would make it easier for the secured creditor to raise the necessary funds for business rehabilitation. It would also be possible for the secured creditor to enforce the security right out of court and sell the business by making use of know-how on mergers and acquisitions.

Thus, the IP Supplement aims to achieve the policy purpose of promoting intellectual property finance by strengthening the right of the secured creditor. Looking at it another way, the IP Supplement issues an alert that unless the right of the secured creditor is strengthened to that extent, it would be difficult to promote intellectual property finance.

Ⅳ Connection with the Applicable Law: Where the Encumbered Assets Include Intellectual Property Protected in a Foreign State

Theoretically, the applicable law may become an issue in various cases that deal with security rights in intellectual property. This section focuses the discussion on the simplest and most realistic case: where the debtor's assets, encumbered as security, include intellectual property protected in a foreign state.

1 Principle of territoriality vs. Law of the State of the Debtor's Location

The principle of territoriality and the law of the State of the debtor's location, which are the rules under private international law for determining the applicable law, are briefly reviewed below, and the advantages and disadvantages of the respective rules in the context of dealing with security rights in intellectual property are examined.

(1) Definitions of the principle of territoriality and the law of the State of the debtor's location

There are two rules that may be employed to determine which law to apply to security rights in intellectual property. One is the principle of territoriality. According to this principle, the effect of intellectual property established in Japan shall be recognized only in Japan. The existing intellectual property law is built based on this principle. [22] When this principle applies, a security right that encumbers an intellectual property right established in State X shall be governed by the law of State X, a security right that encumbers an intellectual property right established in State Y shall be governed by the law of State Y, and a security right that encumbers an intellectual property right established in State Z shall be governed by the law of State Z. Hence, even where a net of security is stretched over all encumbered assets on a substantive law level, the all-inclusive net would be cut into pieces on a conflict-of-laws level.

The other rule is to apply the law of the State of the debtor's location to govern security rights in intellectual property. This approach has been rapidly gaining wider support in recent years as the law applicable to security rights in assets and receivables. According to this rule, in a case where the debtor is located in State X, not only a security right that encumbers an intellectual property right established in State X but also security rights that encumber an intellectual property right established in State Y and an intellectual property right established in State Z shall be governed by the law of the State of the debtor's location, that is, the law of State X. In such a case, the all-inclusive nature of a security right in intellectual property under the Guide and the IP Supplement would be able to fulfill its purpose on an international level.

(2) Relationship with cross-border insolvency law

When determining which law to apply to a security right, it is necessary to take cross-border insolvency law into account because, in the stage of enforcement of a security right, the debtor is in default and nearly insolvent. Therefore, a large gap between the law that governs an international aspect of security rights in intellectual property and the law that governs cross-border insolvency should be avoided.

As for cross-border insolvency, in line with the 1997 Model Law on Cross-Border Insolvency and other reference materials published by UNCITRAL, a framework of international harmonization in procedural aspects has been developed rapidly among the major States, in an effort to overcome the principle of territoriality. Japan has finished enactment of a set of cross-border insolvency laws in accordance with the UNCITRAL Model Law. According to these recent trends, the basic principle is to extend the effect of an insolvency proceeding that has been commenced in the debtor's state (State X) to as many of the debtor's assets located in other States (State Y and State Z) as possible. Through

this approach, equal treatment among creditors of different nationalities can be achieved, and the costs for insolvency proceedings can be considerably reduced, thereby increasing the debtor's liquidation value or promoting the debtor's rehabilitation.[23]

(3) Comparison of advantages and disadvantages

Based on the points mentioned above, let us compare the advantages and disadvantages of the two rules for determining which law to apply to security rights in intellectual property. According to the principle of territoriality, it is possible to have both ownership rights and security rights in intellectual property governed by the same law (S, page 133). This assures consistency between the vertical and horizontal relationships shown in Figure 1 and allows a secured transactions law to be incorporated in an international context without causing conflict with the existing intellectual property law. On the other hand, under the principle of territoriality, if a portfolio of encumbered assets includes intellectual property rights protected in different States, it is necessary to meet the requirements for perfection of the security right in each protecting State, and this would increase costs for registration of the security right (S, page 133). Furthermore, if an insolvency proceeding is commenced in the State where the debtor is located, the law of the State of protection would be applied only to a limited extent by reason of being contrary to public policy in said State or mandatory law considerations (S, page 133). Thus, the principle of territoriality is not affirmed in an emergency. Adopting this principle nonetheless as the rule for determining the applicable law under normal conditions may deprive secured creditors of the benefits that they could have enjoyed under the law of the State of the debtor's location (S, page 133). In short, the principle of territoriality does not provide an international law that can vigorously promote intellectual property finance.

On the other hand, under the law of the State of the debtor's location, the secured creditor can manage all of the debtor's present and future intangible assets under a single law (S, para. 291). This would reduce registration and search costs and enhance the availability of credit (S, para. 291). In addition, it is often the case that the State of the debtor's location is also the State where an insolvency proceeding is commenced. As a result, one and the same law is to govern both normal conditions and an emergency, leading to increased predictability and legal stability (S, page. 292).

2 Details of the Four Recommendations and Their Common Features

From the entire discussion made thus far, the law of the State of the debtor's location seems to be appropriate as the law applicable to security rights in intellectual property. However, the IP Supplement does not recommend the approach based on the law of the State of the debtor's location. The issue of the applicable law is said to have been one of the most controversial issues in the drafting process. The IP Supplement discusses four recommendations, hereinafter referred to as Recommendations A, B and C, and Final Recommendation.[24]

Recommendation A provides that the law of the State of the debtor's location shall apply in principle to security rights in intellectual property, with the exception that the third-party effectiveness and priority of a security right as against a transferee or licensee of intellectual property would be governed under the principle of territoriality.

On the other hand, the Final Recommendation provides that only the enforcement of a security right in intellectual property shall be subject to the law of the State of the debtor's location, and other matters shall basically be governed under the principle of territoriality. The choice of law is allowed to some extent with regard to the creation and third-party effectiveness of a security right in intellectual property, which may be subject to either the law of the State of the debtor's location or the law of the State of protection. However, the Final Recommendation adopts an approach wherein a security right that meets the requirements under the law of the State of the debtor's location may be made effective only against the debtor's insolvency representative or judgment creditors.

The comparison of these four recommendations is shown in Figure 2, in which "D" represents the "law of the State of the debtor's location" and "T" represents the "principle of territoriality."

	Approach. A		Approach. B		Approach. C		Recommendation
			Registered in the IP registry	Not registered in the IP registry			
Creation	D		T	D	D * "T" may also apply by agreement.		T or D
	Secured creditor Insolvency representative	Transferee Licensee			Insolvency representative	Transferee, licensee, secured creditor	
Third-party effectiveness	D	T	T	T	D	T	T or D * "D" may apply only against judgment creditors and the insolvency representative.
Priority	D	T	T	T	D	T	T
Enforcement	D		D		D * "T" may also apply by agreement.		D

Figure 2 Four Approaches

As shown in Figure 2, not only one law, either the principle of territoriality or the law of the State of the debtor's location, is recommended as the law to apply to security rights in intellectual property. Rather, all recommendations divide a security right in intellectual property into four aspects—namely, creation, third-party effectiveness, priority and enforcement—and choose the best law to govern each aspect. Another common feature of the four recommendations is that the law of the State of the debtor's location is basically chosen in relation to the creation and enforcement of a security right in intellectual property, with some variations in conditions attached. To put it differently, the principle of territoriality is chosen mainly on the aspects of the third-party effectiveness and priority. This raises the question, "What causes this tendency?" In the section below, an attempt is made to explore a desirable applicable law, starting with this question.

3 Exploring an Applicable Law That Will Promote Transactions

Before addressing the above question, let us remember that there are dual sources of right information on a substantive law level with regard to intellectual property to be encumbered by a security right (see Figure 1). By considering this issue, which arises mainly in relation to third-party effectiveness and priority of a security right in intellectual property, it will be possible to realize important implications regarding these aspects in the context of conflict of laws.

(1) Transaction costs (domestic transactions)

First, the impact of the existence of dual sources of right information on the arrangement of an intellectual property finance scheme is examined, focusing on domestic transactions. How is a security right in intellectual property created and registered in an actual case? Let us assume that the creditor receives a general security right for ten Japanese intellectual property rights owned by the debtor, and that for all of these intellectual property rights, the debtor is the inventor (or the initial owner).[25] In this case, the creditor needs to investigate whether the intellectual property rights that are supposed to be encumbered by a security right actually exist and belong to the debtor.[26] Since these items of information are managed by means of the

existing intellectual property registry, the creditor has to conduct a search in the registry for each intellectual property right (ten searches in total). If, as a result of the search, the existence and ownership of all intellectual property rights are confirmed, the creditor next needs to investigate whether there is any prior security right that encumbers these intellectual property rights. This time, the creditor has to use the general security rights registry to confirm that there is no prior security right, and if this is confirmed, the creditor can receive and register a security right without anxiety. To sum up, in this hypothetical case, the creditor needs to conduct ten searches in the intellectual property registry, one for each intellectual property right, and conduct one search and make one registration in the general security rights registry by debtor name. Costs incurred from these steps constitute transaction costs.[27]

Next, let us assume a variation of the above case and consider a case where each of the ten intellectual property rights was previously owned by ten different parties (that is, the debtor is the tenth owner of each intellectual property right).[28] In this case as well, the creditor needs to conduct a search in the intellectual property registry for each intellectual property right (ten searches in total) to confirm that all of these rights exist and currently belong to the debtor. Then, the creditor has to confirm whether each of those 100 prior owners of the intellectual property rights, identified through the initial search, has created any security right in the respective intellectual property rights. The matter of concern here is the existence of a secured creditor of the prior owner of each intellectual property right; if such a creditor exists, the security right held by a secured creditor of the current owner might be subordinated. If it becomes clear that no security right has been registered with regard to the 100 prior owners, the creditor can receive and register a security right without anxiety. In the second hypothetical case, costs for conducting 110 searches in total and making one registration in the general security rights registry constitute transaction costs.[29]

(2) Substance of the issue

This discussion focuses on an international level and aims to define the substance of the issue arising in the aspects of the third-party effectiveness and priority of a security right in intellectual property in the context of conflict of laws, by examining how transactions would be affected by the application of either the principle of territoriality or the law of the State of the debtor's location. To examine this point, let us assume the following transaction. The creditor and the debtor are located in State X. Upon providing a loan, the creditor has a security right created to encumber ten intellectual property rights established in State X, ten intellectual property rights established in State Y, and ten intellectual property rights established in State Z—30 rights in total all owned by the debtor. There are 10 prior owners for each of all 30 rights (that is, the debtor is the tenth owner of each right). State X and State Y adopt the IP Supplement and put in place both an intellectual property registry and a general security rights registry. On the other hand, State Z does not adopt the IP Supplement and only has an intellectual property registry.

With regard to costs for arranging this loan transaction, a comparison is made between the principle of territoriality and the law of the State of the debtor's location (see Figure 3). Under the principle of territoriality, the amount of costs incurred in State X for arranging this transaction is the same as the domestic transaction mentioned above, that is, consisting of the costs for 110 searches in total and one registration in the general security rights registry. In State Y, where the creditor is required under the principle of territoriality to meet the perfection requirements as provided for in the law of State Y with regard to a security right that encumbers intellectual property rights established in State Y, the creditor has to pay the same amount of costs as that incurred in State X. In State Z, where only the intellectual property registry exists, the creditor needs to conduct ten searches, one for each intellectual property right, and then register a security right in relation to each intellectual property right.

a) Principle of territoriality

State X

n=10	Per IP	Per debtor	Transaction costs
Search	10	10 × 10	110 searches in total + 1 registration
Regis-tration	-	1	

State Y

n=10	Per IP	Per debtor	Transaction costs
Search	10	10 × 10	110 searches in total + 1 registration
Regis-tration	-	1	

State Z

n=10	Per IP	Per debtor	Transaction costs
Search	10	-	10 searches + 10 registrations
Regis-tration	10	-	

State X: a) = b)

State Y: a) > b)

State Z: a) > b)

b) Law of the State of the debtor's location

State X

n=10	Per IP	Per debtor	Transaction costs
Search	10	10 × 10	110 searches in total + 1 registration
Regis-tration	-	1	

State Y

n=10	Per IP	Per debtor	Transaction costs
Search	10	10 × 10	110 searches in total
Regis-tration	-	-	

State Z

n=10	Per IP	Per debtor	Transaction costs
Search	10	-	10 searches
Regis-tration	-	-	

Figure 3 Transaction costs (international transaction)

The amount of transaction costs incurred in State X under the law of the State of the debtor's location is the same as that under the principle of territoriality. However, in State Y and State Z, where there is no need to meet the perfection requirements, the creditor can save costs for registration in these States. Thus, the law of the State of the debtor's location may be more suitable and more desirable for transactions secured by a security right in intellectual property, in the aspects of the third-party effectiveness and priority, as well as in other aspects.

Then, why do all four of the recommendations in the IP Supplement reject the approach of simply applying the law of the State of the debtor's location to the third-party effectiveness and priority of a security right in intellectual property? Perhaps it's because the advantage of the law of the State of the debtor's location could also become harmful. The fact that State Y and State Z do not require registration of a security right means that the existence of a security right is not publicly disclosed in these States. At the same time, the information on ownership of intellectual property rights established in State Y and State Z is managed by means of the intellectual property registries prepared respectively in these States. This means that the problem of dual sources of right information exists across borders. Under such circumstances, if the law of the State of the debtor's location is adopted, this would greatly undermine the intellectual property laws of State Y and State Z. In other words, it is inappropriate to destroy the vertical relationships that currently function well, in order to invigorate the horizontal relationships.

(3) Final Recommendation vs. Recommendation A

As shown above, it is a big gamble to simply apply the law of the State of the debtor's location to the third-party effectiveness and priority of a security right in intellectual property. One possible approach is to leave these aspects to be subject to the principle of territoriality, so as not to damage the horizontal relationships under the intellectual property laws of the respective States. For example, the Final Recommendation basically follows this approach, while at the same time giving consideration so that the secured creditor, if it follows the law of the State of the debtor's location, would be permitted to make its security right effective against at least the insolvency representative (S, para. 315).

However, this is not the only possible approach. Another approach proposed in the IP Supplement is to divide third parties into two categories and apply different laws to different categories. A typical example of this approach can be found in Recommendation A. Based on this recommendation, the secured creditor must follow the law of the State of the debtor's location

in order to make its security right effective against other secured creditors or the insolvency representative, and must follow the law of the State of protection in order to make its security right effective against a transferee or licensee. Thus, Recommendation A leaves only the issue of the third-party effectiveness as against competing claimants in the vertical relationships to be subject to the principle of territoriality. Because of this, Recommendation A is criticized as increasing registration costs when the secured creditor intends to make its security right effective against all third parties (S, para. 306).

Yet, this could also be an advantage. Recommendation A leaves room for a secured creditor to give a flexible response at low costs depending on the type of risk (S, para. 305). If the secured creditor is mainly concerned with the insolvency of the debtor (and a dispute with other secured creditors that may occur as a result), the creditor can control the horizontal relationships with competing claimants with regard to intellectual property rights established in all States, including the State of the debtor's location, just by registering its security right in the general security rights registry prepared in the State of the debtor's location. On the other hand, if the secured creditor intends to also make its security right effective against competing claimants in the vertical relationships, the creditor has to meet the requirements under the law of each protecting State. In practical terms, it has become a common approach to add to a loan agreement such provisions as to prohibit free disposal of the encumbered assets for the purpose of preventing involvement of competing claimants in the vertical relationships. In such a case, if the debtor transfers or licenses an encumbered intellectual property right, it would constitute a breach of the agreement. For this reason, the risk of involving competing claimants in the vertical relationships is referred to as the risk of fraud. In financing schemes in general, the risk of fraud in this sense is only of a secondary nature as compared to the insolvency risk.[30] Hence, if the main concern of the secured creditor is the insolvency risk rather than the risk of fraud, Recommendation A, which can lower the costs for meeting the requirements for third-party effectiveness in the horizontal relationships, would be considerably attractive to the secured creditor.

Recommendation A also has a disadvantage of requiring costs for investigation in a case where the debtor's assets include any intellectual property right that the debtor has acquired from the initial or intermediate owner located in a State other than the State of the debtor's location. In this case, the secured creditor has to investigate whether the transferor has created or registered any security right for a particular person in the State of the transferor's location (S, para. 293). Hence, if the investigation costs do not exceed the costs that can be saved as explained above, Recommendation A is more desirable than the Final Recommendation.

V Conclusion

If Japan, in earnestness, aims to promote intellectual property finance, it is necessary to first look straight at the current situation where this financing scheme is not frequently used on a national level, and discuss a substantive secured transactions law that is suitable to the characteristics of intellectual property. In this process, the Guide and the IP Supplement will be very helpful references. And if Japan goes ahead with the construction of a general secured transactions law that is recommended in the Guide and the IP Supplement, it is necessary to consider adopting Recommendation A, which can embody the legal policy of promoting intellectual property financing transactions most faithfully on an international level, as the law to apply to security rights in intellectual property.

However, there is no guarantee that all States will make the same conflict-of-laws rules. In such a situation, if Japan alone adopts Recommendation A, this would bring about the adverse consequence that security rights held by Japanese entities may not be effective or enforceable in foreign States, thus bringing secured transactions at a serious risk, rather than saving costs. The IP Supplement mentions this point as another disadvantage of Recommendation A (S, para. 306). Therefore, at present, there is no choice but to adopt the Final Recommendation, rather than Recommendation A.

Be that as it may, it is obvious that the Final Recommendation is not a definite solution to the problems arising in relation to security rights in intellectual property on an international level. The conflict-of-laws rules based on the Final Recommendation are nothing more than a desirable solution when States try to address the problems by referring to the Guide. It would rather be said that the discussion on conflict-of-laws rules in the IP Supplement highlights the limitations in solving the problems by providing a legal form (a legislative guide) or

by providing a methodology (an applicable law). For example, to solve the problem of dual sources of right information under substantive law, coordination of the intellectual property registry and the general security rights registry through the application of electronic technology has been proposed,[31] and how to compile these registries to enable this idea is being discussed at UNCITRAL.[32] Persistent efforts in this direction will bring about a definite solution to this problem over a medium term. In this respect, the IP Supplement has opened up a discussion process toward building national and international laws relating to security rights in intellectual property.

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1 Satoshi Tomii, "Kinyū Kikan kara mita Chiteki Zaisan Tanpo" (Security rights in intellectual property from the viewpoint of financial institutions), Kaoru Kamata, ed., *Chiteki Zaisan Tanpo no Riron to Jissen* (Theory and practice of security rights in intellectual property), pp. 167–168 (Institute of Intellectual Property, 1997).

2 Article 13, paragraph (1) of the Registration and License Tax Act.

3 Nishimura & Asahi, ed. *Atarashii Fainansu Shuhō* (New financing techniques), p. 208 [Shinto Teramoto] (Kinzai Institute for Financial Affairs, 2008).

4 Tomii, 1997, supra note 1, pp. 167–168.

5 Kamata, Kaoru, ed. *Saiken, Dōsan, Chizai Tanpo Riyō no Jitsumu* (The practice of using security rights in receivables, movable assets and intellectual property), p. 369 [Shinichiro Yoshiba, Tatsushi Omiya] (Shinnippon Hoki Publishing, 2008).

6 Nishimura & Asahi, ed., 2008, supra note 3, pp. 209–210 [Teramoto].

7 Kamata, ed., 2008, supra note 5, pp. 381–382 [Yoshiba, Omiya].

8 Article 95 of the Patent Act and Article 34, paragraph (1) of the Trademark Act.

9 Article 96 of the Patent Act and Article 34, paragraph (2) of the Trademark Act.

10 Intellectual Property Policy Office, Ministry of Economy, Trade and Industry, *Chiteki Zaisan no Ryūtsū, Shikin Chōtatsu Jirei Chōsa Hōkokusho: Me ni Mienai Keiei Shigen no Katsuyō* (Case study report on marketing of intellectual property and financing with the use of intellectual property: Effective use of invisible management resources), p. 49 (2007).

11 Kaoru Kamata, "Chiteki Zaisan Tanpo no Igi to Kadai" (Meaning and challenges of security rights in intellectual property), Kaoru Kamata, ed., *Chiteki Zaisan Tanpo no Riron to Jissen* (Theory and practice of security rights in intellectual property), p. 1 (Institute of Intellectual Property, 1997).

12 Kamata, 1997, supra note 11, p. 1, and Tomii, 1997, supra note 1, p. 156.

13 Kamata, 1997, supra note 11, p. 1.

14 See Tomii, 1997, supra note 1, pp. 156–157, and Philip Wood, *Comparative Law of Security Interests and Title Finance* (2nd ed.), pp. 608–609 (2007).

15 Kamata, 1997, supra note 11, pp. 4–6.

16 Intellectual Property Policy Office, Ministry of Economy, Trade and Industry, 2007, supra note 10, p. 47.

17 For the Guide, see Masami Okino, "UNCITRAL Tanpo Torihiki Rippō Gaido no Sakutei" (Compilation of the UNCITRAL Legislative Guide on Secured Transactions), *Junkan Kinyū Hōmu Jijō* (Financial Law Journal, quarterly) Vol. 56, No. 20, pp. 14 ff. (2008), and Masami Okino, "UNCITRAL Tanpo Torihiki Rippō Gaido no Sakutei" (Compilation of the UNCITRAL Legislative Guide on Secured Transactions), *Kinyūhō Kenkyū* Vol. 25, pp. 3 ff. (2009).

18 The IP Supplement is discussed by Naoko Ono, "Chiteki Zaisan no Tanposei: Torihiki to iu sokumen kara mita Chiteki Zaisanhō Seido no Genjō to Kadai [1, 2]" (Security nature of intellectual property: Current situation and challenges of the intellectual property law viewed from the aspect of transactions [1, 2]), *Hitotsubashi Hogaku* (The Hitotsubashi journal of law and international studies), Vol. 11, No. 2, pp. 623 ff., and No. 3, pp. 933 ff. (2012).

19 Brennan clearly argued that controlling the vertical and horizontal relationships concerning intellectual property would be a key to designing a law on security rights in intellectual property (Lorin Brennan, "Intellectual Property Financing: An Overview," p. 10 (2009) available at: http://www.uncitral.org/pdf/english/colloquia/3rdSecTrans/Lorin_Brennan_Edited.pdf.

20 For the same legal policy provided for in Article 9 of the United States Uniform Commercial Code, on which the Guide was modeled, see Osamu Morita, *Amerika Tōsan Tanpohō: Shoki Yūshisha no Yū etsu no Hōri* (United States insolvency security law: the doctrine of Financier Dominance), pp. 45 ff. (Shojihomu, 2005).

21 Tomii, 1997, supra note 1, p. 158.

22 Hidetaka Aizawa, Nishimura & Asahi, ed., *Chiteki Zaisanhō Gaisetsu* (Overview of intellectual property law), p. 428 (Kobundo, 4th edition, 2010).

23 Samuel L. Bufford, "Global Venue Controls Are Coming: A Reply to Professor LoPucki," 79 *American Bankruptcy Law Journal* 105, 141 (2005). For the Japanese translation of this article, see Kazuhiro Yanagida, "Kokusai Tōsanhō Jiken ni okeru Hōteichi Kontorōru [Jō, Chū, Ge]" (Forum control in cross-border insolvency cases [Volumes 1, 2, and 3]), *Kokusai Shōji Hōmu* Vol. 36, No. 1, pp. 4 ff., No. 2, pp. 191 ff., and No. 3, pp. 319 ff. (2008).

24 For the outlines of the four recommendations, see S, para. 304 for Recommendation A, para. 307 for Recommendation B, para. 311 for Recommendation C, and rec. 248 and para. 314 for Final Recommendation.

25 The content of this paragraph largely relies on the analysis provided in the IP Supplement with regard to transaction costs incurred to ensure the third-party effectiveness and priority of a security right in intellectual property, using hypothetical cases (para. 150–151).

26 Kamata, ed., 2008, supra note 5, pp. 377–378 [Yoshiba, Omiya]

27 In this hypothetical case, it is assumed that the creditor registers a security right in the general security rights registry. However, if the creditor intends to avoid the risk of debtor's fraud, the creditor may be likely to register in the intellectual property registry, in which

case registration costs for ten rights at the maximum would be required.

[28] The content in this paragraph largely relies on the analysis provided in the IP Supplement with regard to transaction costs, using a hypothetical case (para. 152).

[29] In this hypothetical case as well, it is assumed that the creditor registers a security right in the general security rights registry.

[30] Wood states that in the context of security rights in assets in general, because of this clause, the secured creditor would not find the effectiveness of its security right against the asset purchaser to be more important than the effectiveness against other secured creditors (Wood, 2008, supra note 14, p. 275).

[31] The IP Supplement proposes two systems, a mutual forwarding system and a common gateway system (para. 139 and 140).

[32] Working Group VI (Security Interests) has been working on the "Draft Technical Legislative Guide on the Implementation of a Security Rights Registry." http://www.uncitral.org/uncitral/commission/working_groups/6Security_Interests.html (last accessed on March 23, 2013).