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SECURITY INTERESTS IN COPYRIGHTS: THE NINTH CIRCUIT CLOSES THE LOOP AND HOLDS THAT ARTICLE 9 GOVERNS PERFECTION OF UNREGISTERED COPYRIGHTS

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Completing the continuum of decisions from courts in the Ninth Circuit since the decision in Peregrine*, the Ninth Circuit has closed the loop on the question of whether federal law or the Uniform Commercial Code controls perfection of security interests in copyright collateral. In doing so, the Ninth Circuit has addressed the ambiguity left open by* Peregrine *and has addressed the last open issue in its decisions dealing with the perfection of security interests in intellectual property collateral. The Ninth Circuit's decision is significant for lenders and borrowers and means that lenders and borrowers should reevaluate the steps they take to perfect, protect and maintain their security interests in copyright collateral.*

Patents, copyrights and other forms of intellectual property constitute "general intangibles" under Article 9 of the Uniform Commercial Code.[1] As anyone familiar with the creation and establishment of interests in intellectual property is aware, there are federal statutes that deal with the creation of rights in intellectual property including the establishment of federal filing systems for the effectuation of recording, transferring, or assigning various forms of intellectual property.

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Over the past 10 years, the U.S. Court of Appeals for the Ninth Circuit and lower courts within the Ninth Circuit have addressed the interplay between the federal statutes governing intellectual property rights and the UCC. The three significant decisions that address this interplay are *National Peregrine, Inc. v. Capital Federal Savings & Loan Ass'n (In re Peregrine Entertainment, Ltd.)*;[2] *Cybernetic Services Inc. v. Matsco Inc. (In re Cybernetic Services Inc.)*;[3] and *Aerocon Engineering, Inc. v. Silicon Valley Bank (In re World Auxiliary Power Company)*.[4]

PEREGRINE

The narrow issue in *Peregrine* was the "perfection" of copyright collateral and related receivables for the purposes of Section 544(a) of title 11 of the United States Code (the "Bankruptcy Code"). In *Peregrine*, the secured party sought to enforce a security agreement covering film copyrights. The secured party had filed UCC-1 financial statements covering the collateral described in the security agreement in the appropriate filing offices. The secured party did not, however, record the security agreement or a memorandum thereof or a mortgage of copyright in the Copyright Office. After filing for bankruptcy, the debtor argued that the bankruptcy court should treat the secured party's security interest as unperfected due to the lack of a filing in the Copyright Office. If the secured party's interest was unperfected under the Copyright Act, then it would be subordinate to any other lien creditor and, because the debtor had the rights of a hypothetical lien creditor under Section 544(a) of the Bankruptcy Code, the secured party's security interest could be avoided.[5]

In *Peregrine*, the District Court for the Central District of California held that because the Copyright Act preempts any state recordation system pertaining to interests in copyrights, Article 9's framework for perfecting security interests does not apply to copyrights. The court went on to hold that in order to perfect a security interest in a copyright, a filing under Article 9 of the UCC is insufficient. Instead, the secured party must record the copyright under Section 205 of the Copyright Act with the Copyright Office in order to be perfected. The court also applied its holding to related licenses and accounts receivable on the rational that they are integral to the copyright.[6] Thus, the *Peregrine* court concluded that the debtor, as a

hypothetical judicial lien holder, could have recorded its interest in the Copyright Office and, therefore, avoided the security interest of the secured party that failed to record its security agreement with the Copyright Office.

Subsequent to *Peregrine*, many cases and commentators have questioned the court's decision both with respect to the fact that the *Peregrine* court did not appear to distinguish between registered and unregistered copyrights and with respect to the fact that the court extended its holding to intangibles related to copyrights.

CYBERNETIC

In *Cybernetic*, the Ninth Circuit became the first circuit court to address the interplay between Article 9 of the UCC and the Patent Act. The Ninth Circuit held that a creditor's security interest in a patent was superior to the interest of a bankruptcy trustee even though the creditor did not record its interest with the Patent and Trademark Office (the "PTO").

Cybernetic granted the secured party a blanket security interest in all of its assets including general intangibles. The secured party recorded its security interest with the appropriate filing offices in accordance with Article 9 of the UCC. The secured party did not file anything with the PTO. Cybernetic was forced into an involuntary chapter 7 case. The primary asset of the bankruptcy estate was a patent on Cybernetic's technology. The secured party brought a motion in the bankruptcy court for relief from the automatic stay to foreclose on its collateral. The chapter 7 trustee opposed the motion contending that the failure to record with the PTO rendered the secured party's security interest unperfected and, therefore, inferior to that of the trustee by virtue of the trustee's status as a hypothetical lien creditor. Thus, the trustee asserted that the Patent Act preempted Article 9's filing requirement and required a federal filing. The Ninth Circuit rejected the trustee's arguments and ruled in favor of the secured party.[7]

In reaching its conclusion, the Ninth Circuit analyzed both the Patent Act and Article 9 of the UCC.[8] The *Cybernetic* court concluded that the Patent Act only requires filings for transactions that affect a transfer of ownership interest in a patent and that all other filings were permissive. The court went on to reason that a security interest in a patent was tantamount

to a license and did not represent the kind of conveyance of an interest that would require a filing or recording with the PTO.[9] Similarly, the court found that the Patent Act renders unrecorded conveyances void as against only a subsequent purchaser or a mortgagee of the patent. The court found that the chapter 7 trustee as a hypothetical lien creditor was neither a subsequent purchaser nor mortgagee of the patent.[10]

According to *Cybernetic*, since the Patent Act did not require the filing of non-assignment interests such as liens, state law was not preempted by federal law. Thus, a secured party could perfect a security interest in a patent by filing a UCC-1 financing statement in accordance with Article 9 of the UCC. As a result, the secured party in *Cybernetic* prevailed over the chapter 7 trustee. Finally, the *Cybernetic* court noted in dicta that the fact that the PTO, as a matter of course, accepts for filings virtually any agreement affecting title to a patent, including security agreements, does not mean that all such interests must be recorded.[11]

WORLD AUXILIARY

On the heels of *Cybernetic*, in *World Auxiliary*, the Ninth Circuit addressed whether federal or state law governs priority of security interests in unregistered copyrights. Although the factual details of the *World Auxiliary* case are complex, the relevant facts can be summarized as a dispute over unregistered copyrights. The secured party received a security interest in the copyrights of the debtor's drawings, blueprints and related software. None of the secured party's copyright collateral was registered with the Federal Copyright Office on the date when the debtor filed for bankruptcy or on the date when the secured party perfected its security interest. The secured party perfected its security interest under Article 9 of the UCC. The secured party did not record its interest under Section 205 of the Copyright Act. The bankruptcy trustees sold the same copyright collateral to a third party as part of Cybernetic's bankruptcy case. The company that acquired the copyright collateral sought to avoid the secured party's security interest in the copyright collateral on the grounds that the secured party's interest in the collateral was inferior to that the of the bankruptcy trustee's because of the trustee's position as a hypothetical lien creditor and because the secured party should have

recorded its security interest with the Copyright Office.[12]

While the Ninth Circuit recognized the interplay of both copyright and bankruptcy law framed the dispute, the court stated that the precise "legal issue is priority of security interests."[13] The court went on to reason that whether the company that acquired the copyright collateral would take priority as a hypothetical lien creditor turns on whether federal or state law governs the perfection of security interests in unregistered copyrights. In deciding the issues presented on appeal, the court looked to the bankruptcy court's published opinion in this case (which the court affirmed largely based on the reasoning contained in the bankruptcy court's decision) and the decision in *Peregrine.*[14]

Unlike *Peregrine*, however, the *World Auxiliary* court held for the secured party on the theory that Article 9 of the UCC is not preempted when the copyright collateral is unregistered. The court found that the priority rule in Section 205(d) of the Copyright Act has no application to unregistered copyrights because registration is one of the conditions necessary for "constructive notice" and constructive notice is a condition of recording priority.[15]

In reaching its conclusions, the Ninth Circuit analyzed the Copyright Act and Article 9's "step-back" provisions.[16] With respect to the Copyright Act, while the court found that registration is permissive and not mandatory to avail oneself of infringement remedies and to transfer ownership, a copyrighted work only gets a "title or registration" number if it is registered. The title or registration number allows for there to be constructive notice of someone else's interest in the copyrighted work. Since unregistered works do not get such a number that would be revealed by a "reasonable search," recording a security interest in an unregistered work in the Copyright Office would not give "constructive notice" under the Copyright Act. Without such "constructive notice" such a recording could not preserve a creditor's priority in the unregistered work.[17]

With respect to the UCC "step-back" provisions, the court made several observations. First, the court held that under the UCC's two "step-back" provisions, a security interest in a registered copyright can only be perfected by recording the transfer in the Copyright Office because the Copyright Act "satisfies the broad U.C.C. step-back provisions by creating a priority scheme that 'governs the rights of parties to and third parties affected by

transactions' in registered copyrights and satisfies the narrow step-back provision by creating a single 'national registration' for security interests in registered copyrights."[18] Thus, the court adopted *Peregrine's* holding that the only proper place to file and perfect a security interest in a registered copyright is the Copyright Office.[19]

The court recognized, however, that the issue before it is whether the UCC steps back as to unregistered copyrights. The Ninth Circuit concluded, like the lower bankruptcy court in *World Auxiliary,* that it does not because the Copyright Act does not provide for the rights of secured parties to unregistered copyrights; "it only covers the rights of secured parties in registered copyrights."

As part of its conclusion, the court reasoned that *Peregrine* did not specify whether the copyrights at issue were registered, but that it is probably safe to assume that the *Peregrine* court did not have a case involving unregistered copyrights because the collateral was a movie library that got licensed out to exhibitors and in the ordinary course such films would be covered by registered copyrights.[20] Further, the court reasoned that *Peregrine's* analysis only works if the copyright was registered because the *Peregrine* court held that Congress preempted state law due to the "comprehensive scope of the Copyright's recording provisions."[21] The Copyright Act has a comprehensive scheme for dealing with registered copyrights but is has no such scheme for unregistered copyrights. The court, therefore, adopted *Peregrine* to the extent that *Peregrine's* holding applies to registered copyrights, and the court found that *Peregrine* does not apply to unregistered copyrights. In finding that *Peregrine* does not apply to unregistered copyrights, the court rejected the lower court opinions in *Zenith Productions, Ltd. v. AEG Acquisition Corp. (In re AEG Acquisition Corp.)*[22] and *In re Avalon Software, Inc.*[23] that extended *Peregrine* to unregistered copyrights.[24]

The Ninth Circuit made a couple of observations as to the implication of extending *Peregrine* to unregistered copyrights. First, the court observed that it "would make registration of copyright a necessary prerequisite of perfecting a security interest in a copyright. The implication of requiring registration as a condition of perfection is that Congress intended to make unregistered copyrights practically useless as collateral, an inference the text and purpose of the Copyright Act do not warrant."[25]

Second, the court observed that Congress must have contemplated that most copyrights would be unregistered, because the Copyright Act only provided for protection of security interests in registered copyrights. The court noted that "[t]here is no reason to infer from Congress's silence as to unregistered copyrights an intent to make such copyrights useless as collateral by preempting state law but not providing any federal priority scheme for unregistered copyrights….The only reasonable inference to draw is that Congress chose not to create a federal scheme for security interests in unregistered copyrights, but left that matter to States, which have traditionally governed security interests."[26]

In sum, as the Ninth Circuit itself stated, the court's decision is premised upon the court's read of the law providing that "unregistered copyrights have value as collateral, discounted by the remote potential for priming."[27]

CONCLUSION

As a result of *Peregrine, Cybernetic* and *World Auxiliary*, a secured party, at least in the Ninth Circuit, now knows that it must prefect a security interest in a registered copyright by filing with the Copyright Office and it must perfect a security interest in a patent and/or unregistered copyright by only filing a financing statement in accordance with the UCC.

In order to protect its interests, a secured creditor should do several things when contemplating a security interest in a patent or copyright.

First, the secured party should perform a UCC search and a search in the PTO and Copyright Office whenever considering a security interest in copyright or patent collateral.

Second, the secured party should nevertheless make dual filings, *i.e.*, UCC-1 financial statements and filings with the Copyright Office and the PTO, whenever possible since a security interest in a patent would not grant the secured party priority over subsequent voluntary assignees of title to the patent (e.g., purchasers and perhaps exclusive licensees).[28]

Third, the secured party should protect itself against subsequent creditors gaining priority (in theory a secured party could take a security interest in an unregistered copyright that is subsequently registered and then pledged to a second secured party who records its interest in the Copyright Office

thereby taking priority) by means of covenants and restrictions on future registering of the copyright collateral and subsequent security interests together with policing mechanisms such as periodic checks of the Copyright Office for registration of the copyright collateral.

NOTES

[1] *See* Rev. U.C.C. § 9-102(42) and comment d.
[2] 116 B.R. 194 (C.D. Cal. 1990).
[3] 252 F.3d 1039 (9th Cir. 2001).
[4] 303 F.3d 1120 (9th Cir. 2002).
[5] 116 B.R. at 204-206.
[6] 116 B.R. at 206-208.
[7] 252 F.3d at 1044; 1059.
[8] *Id.* at 1045-1048.
[9] *Id.* at 1049-1052; 1056-1058.
[10] *Id.* at 1052-1056.
[11] *Id.* at 1056-1058.
[12] 303 F.3d at 1122-1124.
[13] *Id.* at 1125.
[14] *Id.*
[15] *Id.* at 1132.
[16] *Id.* at 1125-1132.
[17] *Id.* at 1125-1126.
[18] *Id.* at 1128 (citation omitted).
[19] *Id.*
[20] *Id.* at 1129-1130.
[21] *Id.* at 1130.
[22] 161 B.R. 50 (B.A.P. 9th Cir. 1993), affirming, 127 B.R. 34 (Bankr. C.D. Cal. 1991).
[23] 209 B.R. 517 (D. Ariz. 1997).
[24] *Id.*
[25] *Id.*
[26] *Id.* at 1131.
[27] *Id.* at 1132.
[28] To the extent that a security interest in a patent takes the form of a "collateral assignment," a federal filing may be required.