CYBERNETIC IMPLICATIONS FOR THE U.C.C.

In the following iBrief, the authors assess the impact of recent a recent decision from the 9th Circuit assessing whether the patent system's filing mechanism preempts the U.C.C. Article 9 requirement that creditors perfect their security interests in patents offered as collateral by their debtors.

BACKGROUND INFORMATION

Article 9 of the Uniform Commercial Code ("U.C.C.") governs transactions in which a debtor, in order to obtain a loan, uses his or her property as collateral for the debt. In this transaction, the creditor takes a "security interest" in the collateral that allows her to take the collateral in the event that the debtor defaults on the loan.[1] Even if the debtor files for bankruptcy, a secured creditor under Article 9 will be guaranteed payment by taking the collateral.

However, to take full advantage of the benefits of the U.C.C., Article 9 requires that the creditor receiving the security interest "perfect" its security interest by filing a financing statement with the appropriate state government official.[2] If the creditor does not file the appropriate financing statement, he or she will not be granted the protections of Article 9.[3]

One limitation to the doctrine of perfection by filing is found in section 9-109(c) which states that filing is not required for perfection if "a statute, regulation, or treaty of the United States whose requirements for a security interest's obtaining priority over the rights of a lien creditor with respect to the property preempt Section 9-310(a)."[4] This provision raises the question addressed by the 9th Circuit in *In re Cybernetic Services Inc.*[5] - whether the mandatory filing system of the patent system preempts the U.C.C., thereby obviating the need to perfect a security interest granted in a patent with the appropriate state official.[6]

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[1] U.C.C. § 9-109(a)(1).

[2] *Id.* § 9-501(a).

[3] *Id.*

[4] *Id.* at §§ 9-109(c)(1); 9-311(a).

[5] 252 F.3d 1039 (9th Cir. 2001) ("Cybernetic I").

[6] *Cybernetic I*, 252 F.3d at 1044.

FACTS

Cybernetic Services, Inc. ("Cybernetic"), a California corporation, borrowed money from Matsco Financial Corporation ("Matsco") on a secured basis.[7] In exchange for the loan, Matsco received a security interest in all of Cybernetic's "general intangible" assets, including one of Cybernetic's patents.[8] In an attempt to perfect this security interest, Matsco filed a financing statement with the Secretary of State of California, but did not file a statement with the Patent and Trademark Office ("PTO") of its security interest in Cybernetic's patent.[9]

After business relationships soured, Cybernetic went into bankruptcy under Chapter 7 of the United States Bankruptcy Code.[10] After learning of the bankruptcy, Matsco foreclosed on the loan and attempted to take possession of the patent.[11] Cybernetic and other creditors opposed this action on grounds that since Matsco had not filed a financing statement with the PTO, it had not properly perfected the security interest and thereby was not entitled to possession of the patent.[12] After a hearing, the Bankruptcy court ruled that Matsco was entitled to relief because it had filed its financing statement properly,[13] whereupon Cybernetic and the other creditors appealed to the 9th Circuit.[14]

HOLDING

To determine whether a party claiming a security interest in a patent is required to file a financing statement with the PTO, the court turned to the *Waterman*[15] case, an old decision that is still the leading case on the issue of recording documents in the PTO. In *Waterman*, the Supreme Court held that whether a conveyance of rights needs to be recorded in the PTO depends on whether the transfer

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[7] *Id.* at 1044.

[8] *In Re Cybernetic Services, Inc.*, 239 B.R. 917, 918 (B.A.P. 9th Cir. 1999) ("Cybernetic II")

[9] *Cybernetic I*, 252 F.3d at 1044.

[10] *Id.*

[11] *Id.*

[12] *Id.*

[13] *Id.*

[14] *Cybernetic I*, 252 F.3d at 1044.

[15] *Waterman v. Mackenzie*, 138 U.S. 255 (1891).

constitutes a grant of an "assignment" or a "mere license."[16] All transfers that constitute assignments are only valid if recorded, whereas the granting of a mere license in the patent has no recording requirement.[17]

According to the Supreme Court, classifying a conveyance as an "assignment" or a "mere license" does not "depend upon the name by which it calls itself, but upon the legal effect of its provisions."[18] The court should look to whether an ownership interest in the patent was granted by the transfer.[19] If the transfer gives a party an ownership interest in the patent, the transfer is properly termed to be an assignment, and thus must be recorded in the PTO to be legally binding on the parties.[20] Similarly, if the transfer conveys an interest in the patent that is less than an ownership interest (i.e. the right to use the invention in a specific geographic area, etc.), the transfer is a mere license, and is not to be recorded in the PTO.[21]

Applying this test to the facts of *Cybernetic*, the court had no problem holding that granting a security interest in the patent does not require recording the transaction with the PTO.[22] Granting a security interest in the patent transfers no ownership rights in the patent.[23] Rather, a security interest is simply collateral for a debt and does not transfer to the holder of a security interest the right to use the patented invention, grant licenses, receive royalty payments from licensees, pay maintenance fees, bring an infringement suit, or exercise any of the other rights associated with patent ownership.[24] The holder of the security interest has a right to be repaid, and if it turns out that the debtor defaults, the holder of the security interest may take action against the debtor pursuant to the security agreement, including taking

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[16] *Id.* at 256.

[17] *See id.*

[18] *Id.*

[19] *See id.*

[20] *See id.*

[21] *See id.*

[22] *See Cybernetic I*, 252 F.3d at 1059.

[23] *See id.* at 1052.

[24] *See id.* at 1050-1052.

ownership of the patent.[25] Yet, without the present rights to ownership of the patent, the grant of a security interest cannot be treated as granting an ownership interest in the patent. As such, the grant of a security interest in a patent constitutes the granting of a "mere license" and does not need to be recorded in the PTO.[26]

The court also supported its holding by citing the rules of the PTO as set forth in the Manual of Patent Examination and Procedures (MPEP).[27] According to MPEP section 313, all "assignments" must be recorded in the PTO, whereas "[o]ther documents affecting title to applications, patents, or registrations will be recorded at the discretion of the Commissioner."[28] These "other documents" specifically include "agreements which convey a security interest...."[29] In other words, it is clear that the PTO does not believe that a security agreement constitutes an assignment, because if the security agreement was an assignment, "they would have to be filed... [and] the Commissioner would not have the 'discretion' to reject the filing."[30]

CONSEQUENCES

While *Cybernetic* has theoretical interest involving the scope of the patent laws in commercial financing transactions, the direct consequences and results of the case do not appear to be significant. *Cybernetic* stands for the proposition that if a party is going to enter into a security agreement in which patent rights are used as collateral, then that party must file a financing statement with the governing state to perfect the security interest in the patent, just as it would with any other type of collateral.[31] Thus, in this respect, the court's holding does not represent a change in existing doctrine.

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[25] *See id.* at 1044.

[26] *See id.* at 1052.

[27] *See id.* at 1067-1057.

[28] *Id.* at 1057.

[29] *Id.*

[30] *Id.*

[31] Assuming the court had decided the case differently, the same search would still have been required. The only difference is that the search would have been performed in the PTO in Washington, D.C., rather than in the state's record office. Thus, on a technical level, the real issue in this case is determining the proper location to conduct the search.

On the other hand, the court's opinion could endanger the priority of many granted security interests. Based upon the logic of various scholars and commentators, it is very likely that many people who presently hold security interests in patent rights have undoubtedly filed the financing statement associated with the security interest with the PTO and not with the appropriate state offices. By declaring that this filing with the PTO does not constitute proper perfection, the court retroactively changes the value of these security interests. Such a result is clearly inequitable and threatens the commercial certainty required for a thriving financial market. While such adverse effects are unlikely, this case does require holders of security interests to go back and double-check that the proper documents have been filed with the state.

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