

Enforceability of Restrictive Clauses in IP Licenses in Secured Transactions

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Funding Problem for R&D in high-tech SMEs

- using IP (including IP licenses) as collateral in debt finance

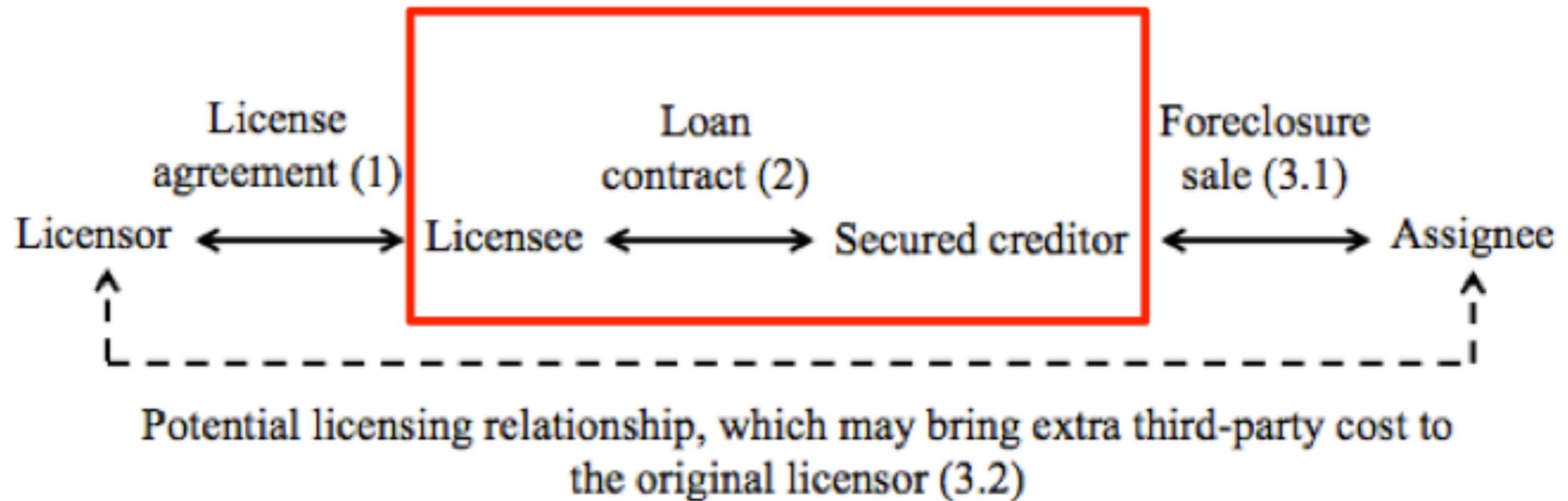
Conditions for being used as collateral

- with monetary value
- can be assigned independently from other assets



Benefits for the licensee's use of IP licenses as collateral

- **Licenses:** leverage the future income from the licenses for the current cash needs for operation and investment.
- **Lenders:** prove the cash flow & safety for investment failure
- **Sociality:** alleviate credit-rationing problem and make more welfare-enhancing projects to be financed



			HTC	1M, 0
Google	Samsung	Bank	Microsoft	2M, 0.5M
			Apple	3M, -6M

A typical restrictive term:

“the licensee should not assign, sell, mortgage, pledge, or in any manner transfer the license contract or any interest herein whether voluntary or involuntary or by operation of law without the prior written consent of the licensor.”

Different Rules on the enforceability of the restrictive terms

China (2010): **strict prohibition**

- the pledger must be the registered IP holder

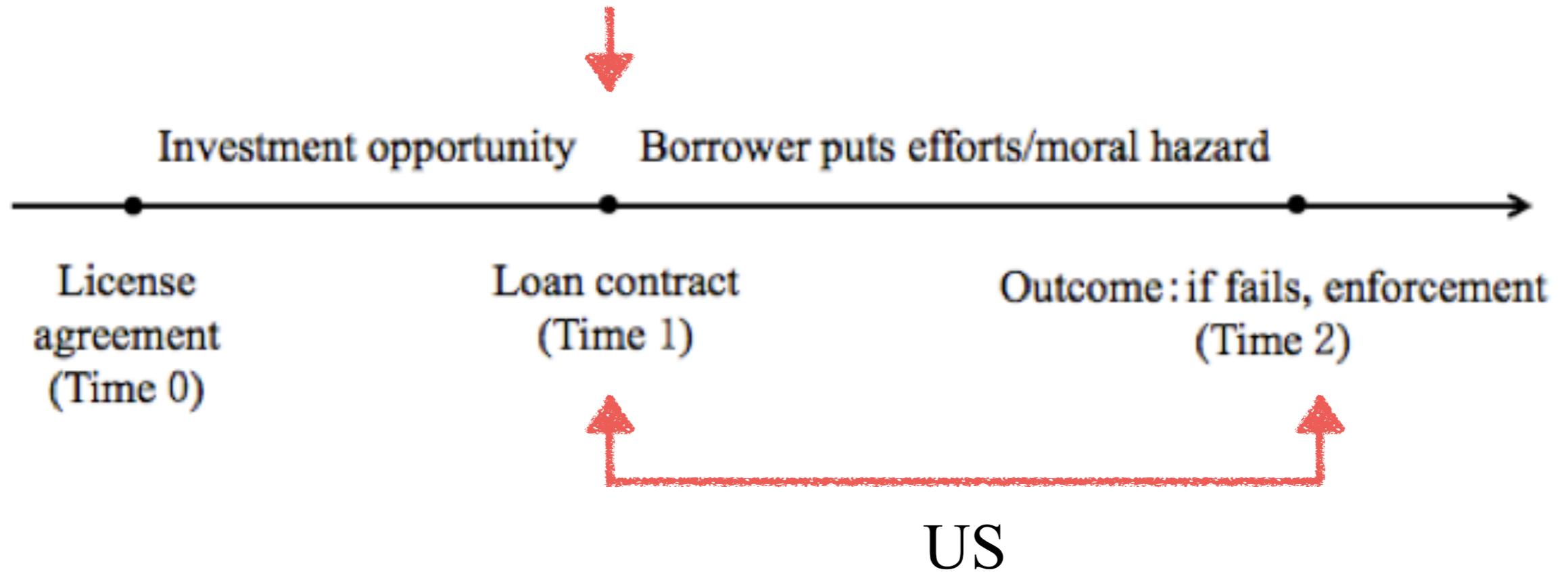
UNCITRAL Legislative Guide on Secured Transactions: Supplement on Security Rights in Intellectual Property (2010): **enforcing restrictions**

In the case with restrictive terms, **no** enforceable security interest can be created **without** the consent of the licensor

U.S. (2011): **limited security interests** allowing the licensees to create **limited security interests withstanding restrictive terms**

- UCC 9-408(a): a restrictive term [...] would be rendered **ineffective against the creditor**;
- UCC 9-408(d): [...] security interest is **not enforceable against the licensor**.
- experience from the Federal Communications Commission (FCC) broadcast licenses

UNCITRAL



Questions:

- 1 - Why should law interfere with contractual restrictions? Any market failure with party negotiation?
- 2 - Does the US rule improve the UNCITRAL rule?

Tirole (2006): Collateral - Moral hazard model for debt finance

- A investment project:

success $R > 0$; failure 0

lending agreement:

$$\overline{U_l(A)} = p_H(1 + \bar{r})I + (1 - p_H)\beta A - I = 0$$

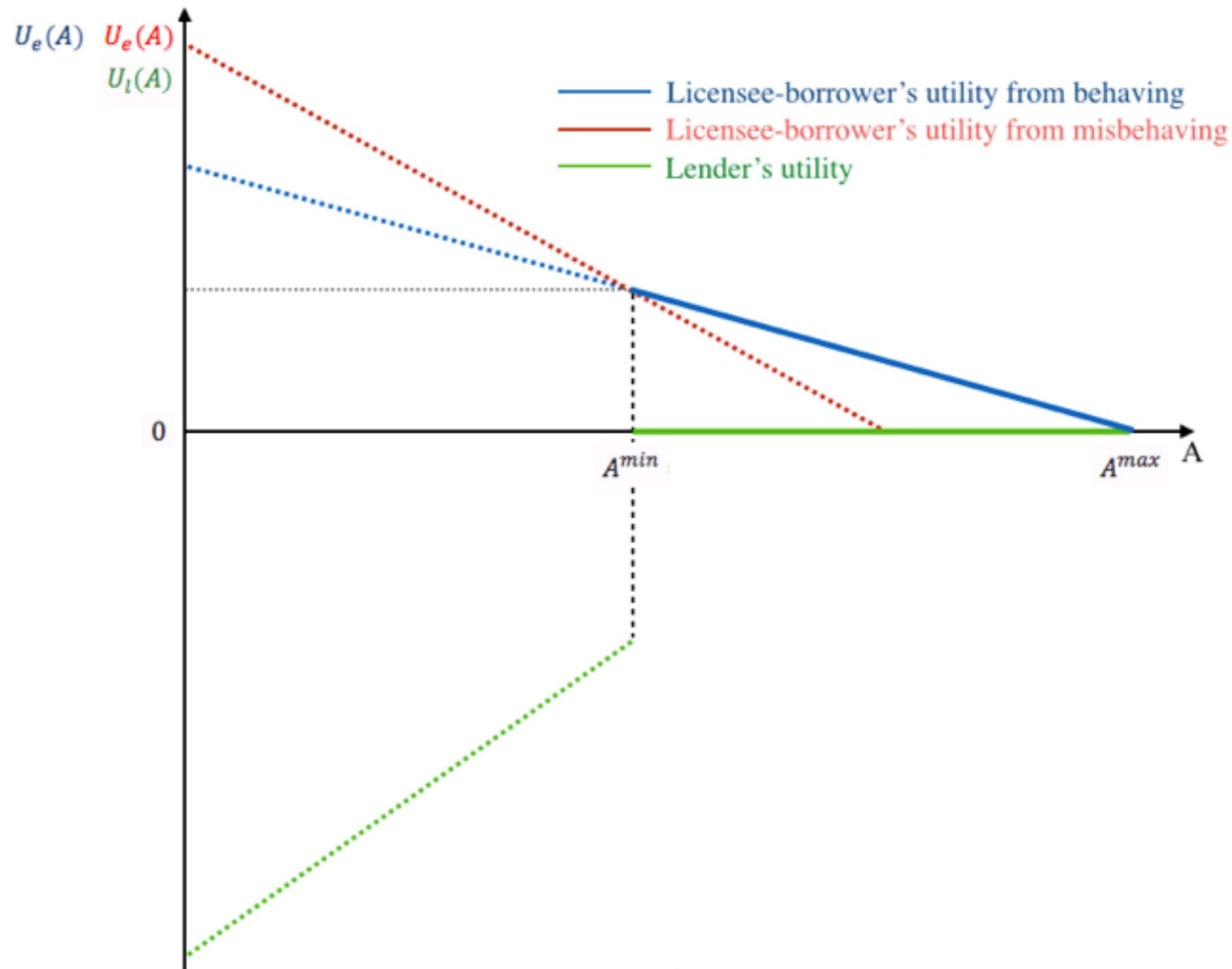
- Moral hazard problem:

with efforts p_H ;

$$\overline{U_e(A)} = p_H [R - (1 + \bar{r})I] - (1 - p_H)A$$

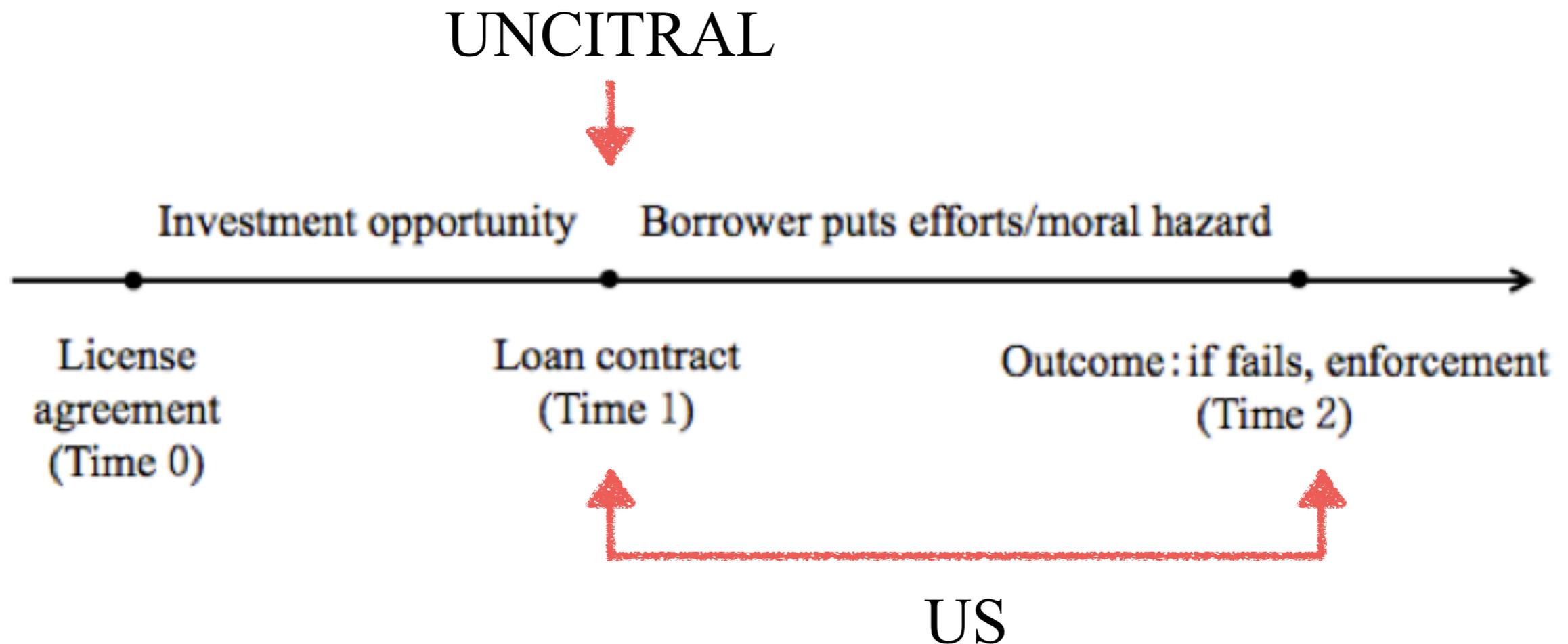
without efforts p_L ,

$$\overline{U_e(A)} = p_L [R - (1 + \bar{r})I] - (1 - p_L)A + B$$



Introducing

- the third party - the licensor
- the third party cost - the potential cost to the licensor, C



Public Licenses: The licensor is risk-averse; **no** incentive to holdup

UNCITRAL Rule: creation

US Rule: enforcement

Lender

$$U_{l_1}(A) = p_H(1 + r_1)I + (1 - p_H)\beta A - I = 0$$

$$U_{l_2}(A) = p_H(1 + r_2)I + (1 - p_H)(\beta A - P_2) - I = 0$$

Licensor

$$U_{o_1}(A) = p_H P_1 - (1 - p_H)C - \Delta U_{o_1}(A, \varepsilon) = 0$$

$$U_{o_2}(A) = P_2 - C = 0$$

Licensee behaves

$$U_{e_1}(A) = p_H[R - (1 + r_1)I - P_1] - (1 - p_H)A$$

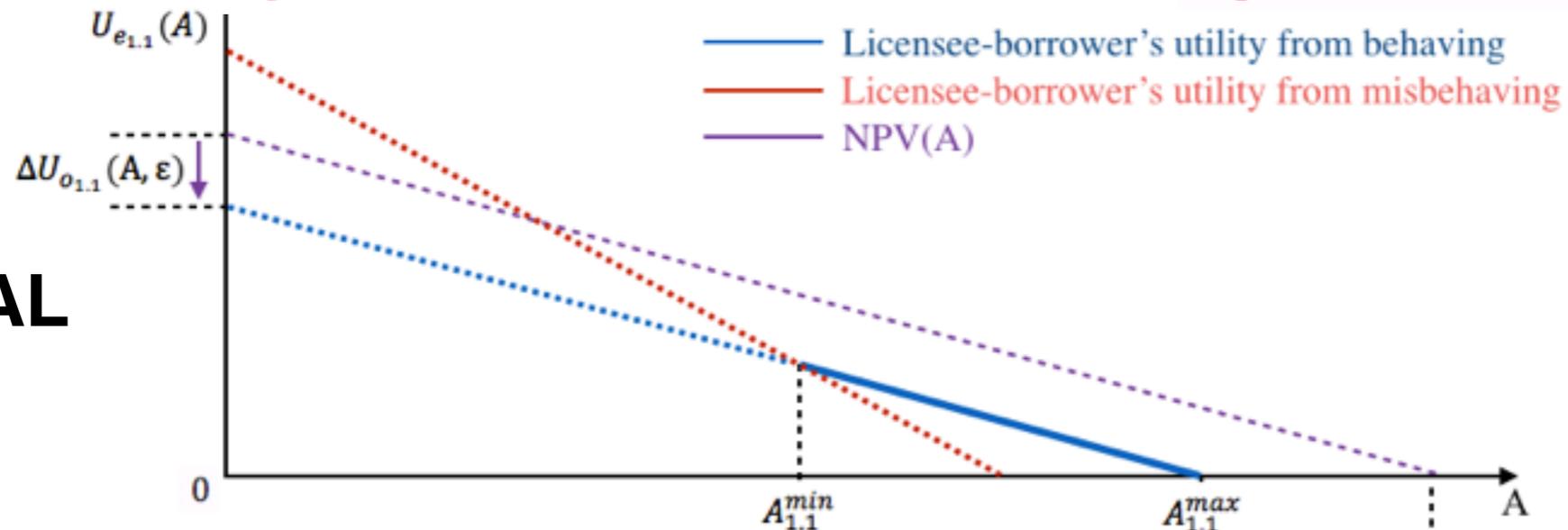
$$U_{e_2}(A) = p_H[R - (1 + r_2)I] - (1 - p_H)A$$

Licensee misbehaves

$$U_{e_1}(A) = p_L[R - (1 + r_1)I - P_1] - (1 - p_L)A + B$$

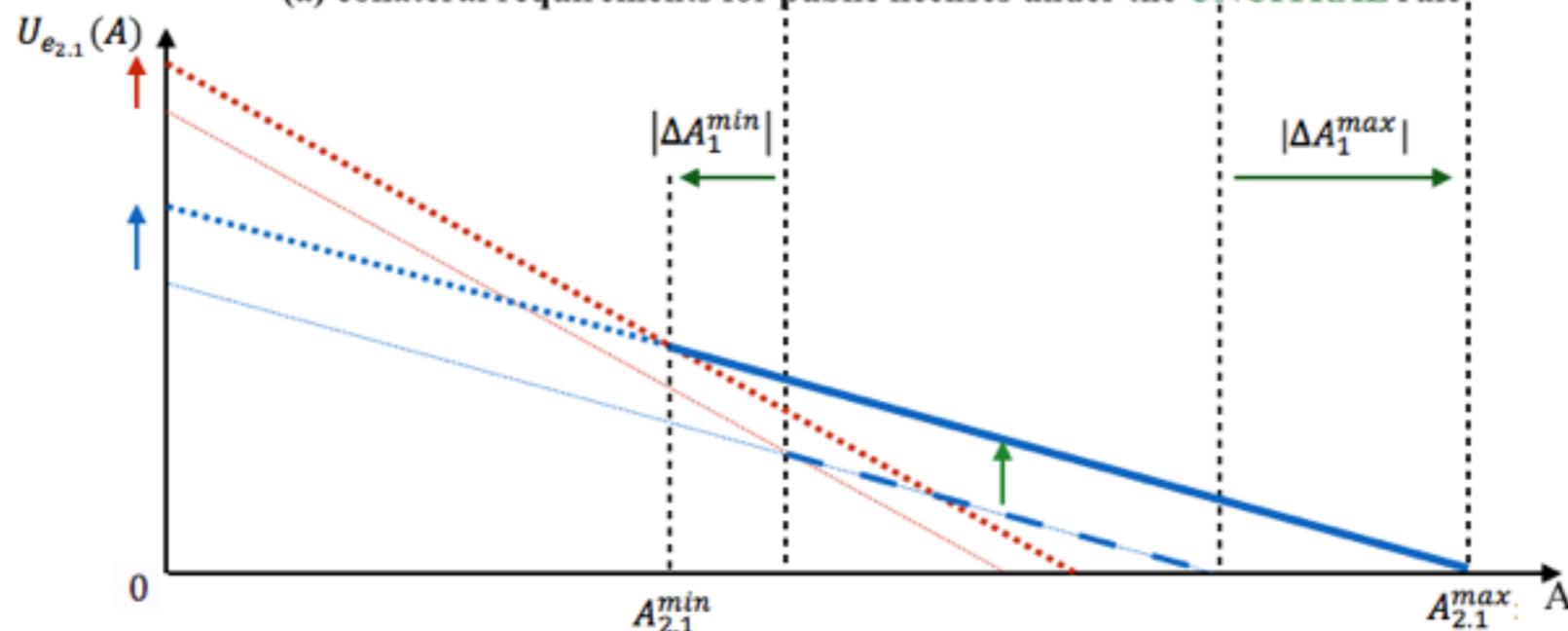
$$U_{e_2}(A) = p_L[R - (1 + r_2)I] - (1 - p_L)A + B$$

UNCITRAL



(a) collateral requirements for public licenses under the **UNCITRAL** rule

US



(b) collateral requirements for public licenses under the **UCC 9-408** rule

Private Licenses: The licensor is risk-averse; incentive to holdup

UNCITRAL Rule: creation

US Rule: enforcement

Lender

$$U_{l_1}(A) = p_H(1+r_1)I + (1-p_H)\beta A - I = 0$$

$$U_{l_2}(A) = p_H(1+r_2)I - I = 0$$

Licensor

$$U_{o_1}(A) = p_H P_1 - (1-p_H)C - \Delta U_{o_1}(A, \epsilon) = \frac{1}{2} \Delta NS_1$$

$$U_{o_2}(A) = (1-p_H)(\beta A - C)$$

Licensee behaves

$$U_{e_1}(A) = p_H[R - (1+r_1)I - P_1] - (1-p_H)A = \frac{1}{2} \Delta NS_1$$

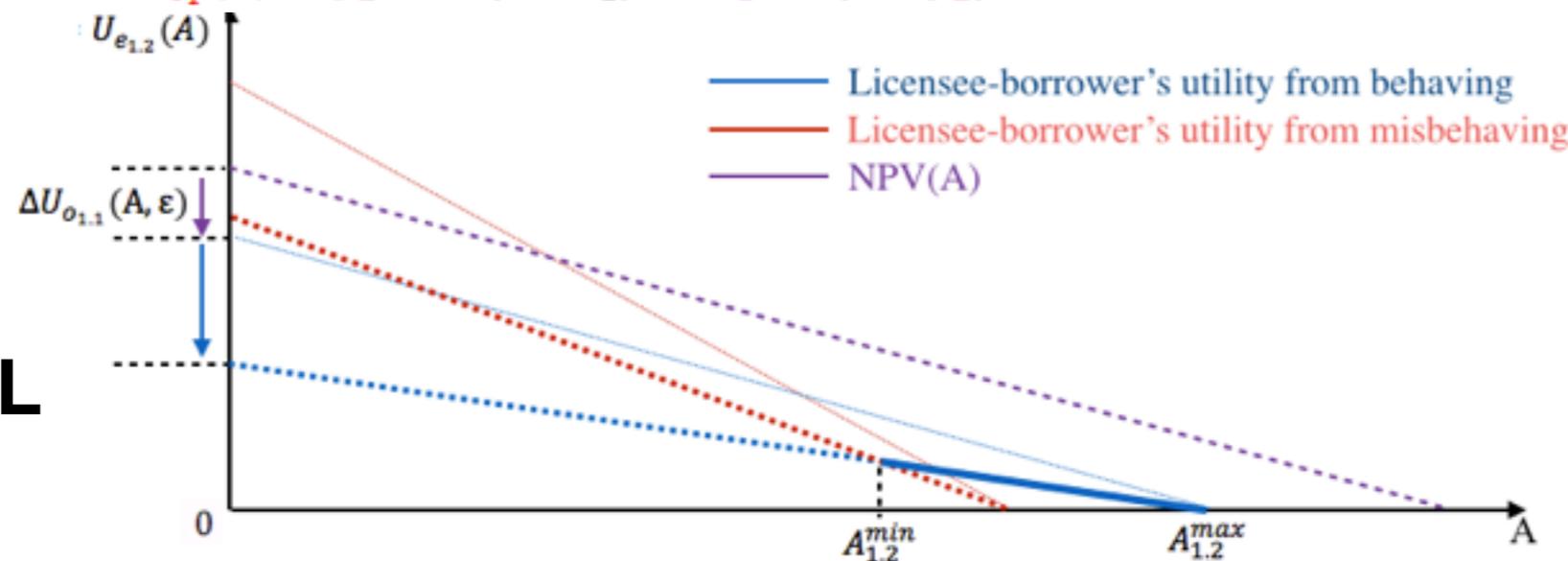
$$U_{e_2}(A) = p_H[R - (1+r_2)I] - (1-p_H)A$$

Licensee misbehaves

$$U_{e_1}(A) = p_L[R - (1+r_1)I - P_1] - (1-p_L)A + B$$

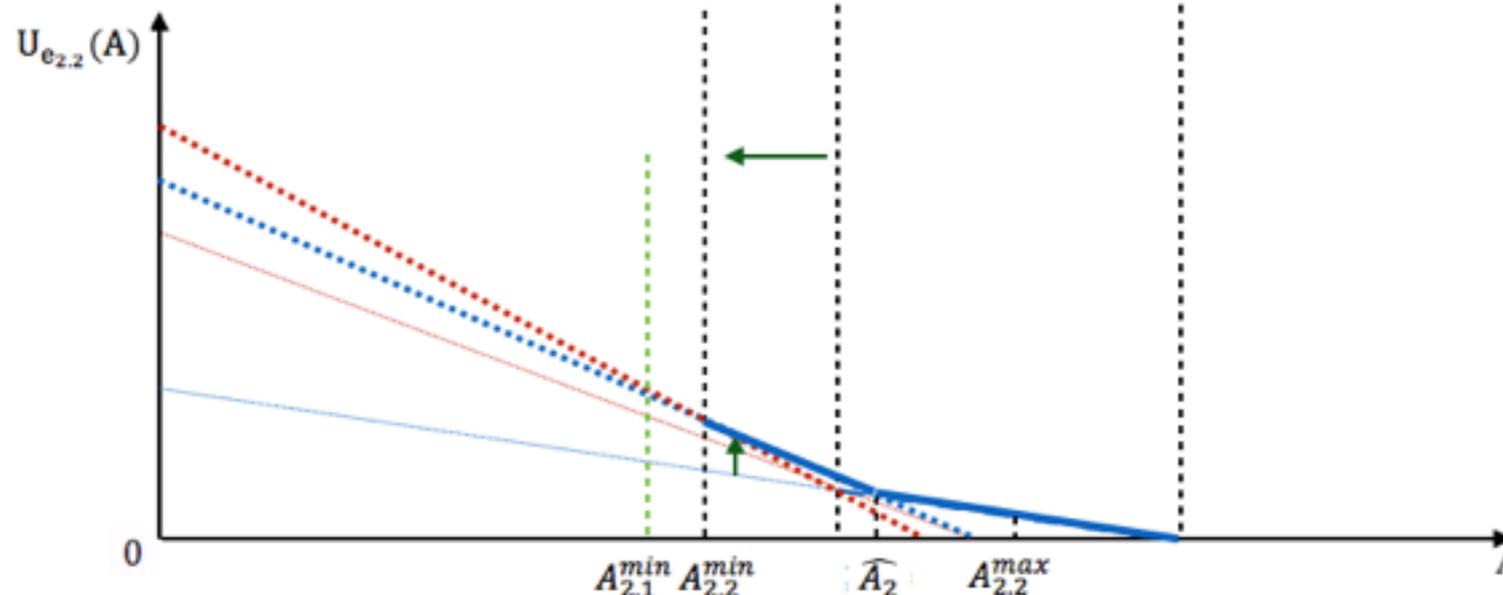
$$U_{e_2}(A) = p_L[R - (1+r_2)I] - (1-p_L)A + B$$

UNCITRAL



(a) collateral requirements for private licenses under the UNCITRAL rule

US



(b) collateral requirements for private licenses under the UCC 9-408 rule
(if the licensor still can holdup at the time of enforcement)

Conclusion:

- 1 - The law shall interfere with contractual restrictions because of **the licensor's risk-aversion** and the **licensor's incentive to holdup**.
- 2 - For **public licenses**, like the FCC licenses as the licensors have no incentive to holdup, the only problem is the **licensors' risk-aversion**. In this case, the US rule changes the time of negotiation and consequently avoids the social deadweight loss in the negotiation.
- 3 - For private licenses, like the IP licenses as the licensors have incentive to holdup. In this case, the US rules just **changes the licensors' time of holdup**. In the end, the US rule can only alleviate the market failure to a very limited extent.
- 4 - We **should not** simply just apply the rules which work in the usual cases to the case of IP collateralization.