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
- **Licensees**: 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
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

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
Questions:
1 - Why should law interfere with contractual restrictions? Any market failure with party negotiation?
2 - Does the US rule improves the UNCITRAL rule?
Tir sole (2006): Collateral - Moral hazard model for debt finance

- A investment project: success $R > 0$; failure $0$
- Lending agreement:
  - Moral hazard problem:
    - with efforts $p_H$;
    - without efforts $p_L$,\[ U_l(A) = p_H (1 + r) I + (1 - p_H) \beta A - I = 0 \]
    \[ U_e(A) = p_H [R - (1 + r) I] - (1 - p_H) A \]
    \[ U_e(A) = p_L [R - (1 + r) I] - (1 - p_L) A + B \]
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**

- Lender (Licensor)
  - Licensee behaves
    - $U_{e1}(A) = p_H[R - (1 + r_1)I - P_1] - (1 - p_H)A + B$
  - Licensee misbehaves
    - $U_{e2}(A) = p_L[R - (1 + r_1)I - P_1] - (1 - p_L)A + B$

**US Rule: enforcement**

- Lender (Licensor)
  - $U_{o1}(A) = p_H P_1 - (1 - p_H)C - \Delta U_{o1}(A, \varepsilon) = 0$
  - $U_{o2}(A) = P_2 - C = 0$

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**Diagram**

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

\[
U_{l1}(A) = p_H(1 + r_1)I + (1 - p_H)\beta A - I = 0
\]

\[
U_{o1}(A) = p_H P_1 - (1 - p_H)C - \Delta U_{o1}(A, \varepsilon) = \frac{1}{2} \Delta NS_1
\]

**US Rule: enforcement**

\[
U_{l2}(A) = p_H(1 + r_2)I - I = 0
\]

\[
U_{o2}(A) = (1 - p_H)(\beta A - C)
\]

Licensee behaves

\[
U_{e1}(A) = p_H[R - (1 + r_1)I - P_1] - (1 - p_H)A = \frac{1}{2} \Delta NS_1
\]

Licensee misbehaves

\[
U_{e1}(A) = p_L[R - (1 + r_1)I - P_1] - (1 - p_L)A + B
\]

\[
U_{e2}(A) = p_H[R - (1 + r_2)I] - (1 - p_H)A
\]

\[
U_{e2}(A) = p_L[R - (1 + r_2)I] - (1 - p_L)A + B
\]
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 lose in the negotiation.

3 - For private licenses, 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.