The Morphing of Property Rules and Liability Rules: An Intellectual Property Optimist Examines Article 9 and Bankruptcy

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Cover Page Footnote
The author thanks Mark Lemley and Jesse Fried for comments on earlier drafts. This Article was written while the author was assistant professor at Oklahoma City University School of Law, which the author thanks for its financial support. This Article is dedicated to the memory of Maria Tai Wolff, Stanford Law School, Class of 1991, for her supportive role as Bankruptcy Law professor and friend.
ARTICLES

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Shubha Ghosh*

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INTRODUCTION

When credit law clashes with creative law, neither prevails. They undermine each other, and the result is extreme uncertainty. Credit law can eviscerate the protections granted by the trinity of copyright, trademark, and patent—destroying legal protections and incentives for the creation, cultivation, marketing, and distribution of artistic works, brand names, marks, and inventions. Conversely, the special protections afforded by copyright, trademark, and patent can impair the predictability that is so necessary to the operation of the credit system that finances creative works.

Although legal protection of rights in intellectual property may be a necessary ingredient in the promotion of creativity, it certainly is not by itself a sufficient foundation for the creation of intellectual property. To the extent that a creator is motivated by profit, financing is a prerequisite to the creation and dissemination of intellectual property. Because debt, rather than equity investment,
is the primary means of financing the creation of many works, the law of secured credit can provide additional incentives and disincentives for participants in the intellectual property regime. Thus the law governing credit transactions, which includes common law contract, article 9 of the Uniform Commercial Code ("U.C.C."), and the Federal Bankruptcy Code, provides crucial support to the laws of copyright, trademark, and patent.

But the law of secured credit often conflicts with the law of intellectual property, as set forth in the Copyright Act and the Lanham Act. Under the current regime, the law of secured credit can undermine much of the property right structure, thereby eviscerating the incentives provided by the Copyright and Lanham


8. This Article ignores patent law because such a complex subject warrants separate treatment. Furthermore, because this Article focuses largely on the entertainment, service, and information industries, the analysis can be more detailed by concentrating on copyright and trademark.


Nevertheless, the use of intellectual property as collateral has expanded over the past decade. Recent headline-making transactions evince the increased use of intellectual property as collateral for start-up and financing ventures.

For example, in 1995, the Hollywood producers Steven Spielberg, Jeffrey Katzenberg, and David Geffen founded DreamWorks, SKG, which was funded by a $1 billion loan, secured largely by intellectual property holdings of the creators, arranged by Chemical Bank. Similarly, Westinghouse Corporation ("Westinghouse") financed its $10 billion bid for CBS through a loan secured by Westinghouse’s intellectual property rights. Orion Pictures Corporation’s experience with bankruptcy proceedings indicated the importance of the use of copyrights as collateral. The distribution of several of Orion’s films, including \textit{Blue Sky}, whose female star won an Academy Award for Best Actress in 1994, was delayed because of attachment by creditors prior to the bankruptcy proceeding.

\begin{enumerate}
\item \footnote{See generally Alice Haemmerli, \textit{Insecurity Interests: Where Intellectual Property and Commercial Law Collide}, 96 \textit{COLUM. L. REV.} 1645, 1647 (1996) ("In such situations, and increasingly as a general matter, lenders have come to appreciate the importance of intellectual property assets to the companies with which they do business."). In 1984 and 1985 together, the U.C.C. filings of seven creditors listed copyrights, but not trademarks or patents, as collateral. Search of LEXIS, LIENS Library, ALLIEN Database (Mar. 27, 1998) (search for filings containing “1984” or “1985” in DATE field and containing “copyright” but not “trademark” or “patent”). A similar search for the years 1994 to 1995 uncovered 74 filings. Search of LEXIS, LIENS Library, ALLIEN Database (Mar. 27, 1998). For patents, the number of filings increased from 56 in 1984-1985 to 619 in 1994-1995. Search of LEXIS, LIENS Library, ALLIEN Database (Mar. 27, 1998). The most dramatic increase, however, was in the use of trademarks, which numbered 61 in 1984-1985 and more than one thousand in 1994-1995. Search of LEXIS, LIENS Library, ALLIEN Database (Mar. 27, 1998).}
\item \footnote{See Monica Roman, \textit{Unknown Chemical Reaction: Unlike bank merger partner, Chase not key player in showbiz finance}, \textit{HOLLYWOOD REP.}, Aug. 29, 1995, at 1.}
\item \footnote{See id. at 6, 177. Many Internet providers finance their service through bank loans collateralized by software. See Steve Cocheo, \textit{Where the 'Net Goes for Money}, A.B.A. BANKING J., Apr. 1996, at 40.}
\item \footnote{See Frank Rose, \textit{Cover Story: No Flowers, Send Money}, \textit{L.A. TIMES}, Dec. 17, 1995, at C8.}
\item \footnote{See Elliot Forbes & David Pierce, \textit{Who owns the movies?}, 30 \textit{FILM COMMENT} 43 (1994); Stan Soocher, \textit{Film industry faces historic crossroads}, 7 \textit{ENT. L. \\& FIN.} 1 (1992). The use of copyrights as collateral was a central problem in the Orion bankruptcy proceedings, in which several banks that had extended lines of credit to Orion claimed secured status in twelve of Orion’s films based on a state U.C.C. filing.}
\end{enumerate}
At one level, the issues are simple and analogous to conflicts that are at the heart of property and contract. All property right systems teeter between the protection of two sometimes conflicting interests: the right of the property right holder to exclude others, and the right of third parties to access the property right. Although property rights often are viewed simply from the perspective of granting exclusion rights, property rights systems often place limitations on the right to exclude when the right to access is more important.

The classic case is of the conflict between the harbor owner and the ship owner, with the latter wanting to dock his ship in the harbor to avoid inclement weather. Although the harbor owner has the right to exclude the ship owner, the common law granted a right of access to ship owners in this situation because of the greater necessity of avoiding the loss of the ship. Even though this rule may be viewed as lessening incentives to build harbors, because of the prospect of opening the harbor to wayward ships the rule promotes economic activity by giving ship owners insurance against loss in the event of being adrift and in need of moorings. Furthermore, the law forces an exchange by requiring the ship owner to compensate the harbor owner for any loss to the property and for its use.

The harbor example illustrates the two principal ways in which a property rights system protects property rights. First, a property rights system can give the property right holder an absolute right to exclude, such as the harbor owner would have against trespassers. The right can be purchased by third parties, but cannot be


17. See id. at 746-47.

18. The facts are a simplification of the classic torts case Vincent v. Lake Erie Transportation Co., 124 N.W. 221 (Minn. 1910). See Epstein, supra note 2, at 55 (discussing the Vincent case); see also Ian Ayres & J.M. Balkin, Legal Entitlements as Auctions: Property Rules, Liability Rules, and Beyond, 106 YALE L.J. 703, 715-16 (1996).

taken. Second, a property rights system can limit the property
owner’s right to exclude by granting third parties a right to “take
and pay.” The latter rule is illustrated by the ship in dire straits
that needs to use the harbor to avoid a greater calamity. Although
the ship owner can gain access to the harbor, the ship owner must
pay for it. The former rule in which the property right must be
bought is referred to as a “property rule;” the latter rule corre-
sponding to take or pay is referred to as a “liability rule.”

Our legal system often involves a mix of property and liability
rules, each designed to protect specific interests in different con-
texts. Often, as is the case with intellectual property and secured
credit, the clash in rules arises from the use of property and liabil-
ity rules to protect different rights. If one examines the ways in
which the protection of competing interests is expressed in our in-
tellectual property laws, some inherent inconsistencies appear.

The Copyright Act protects the copyright owners’ right to re-
produce, adapt, publish, perform, and display the protected work.
These rights attach as soon as the copyright owner puts the work in
a tangible medium of expression.

20. See Tyler E. Chapman, To Save and Save Not: The Historic Preservation Impli-
21. See Vincent, 124 N.W. at 222.
22. See Guido Calabresi & A. Douglas Melamed, Property Rules, Liability, and
Inalienability: One View of the Cathedral, 85 HARV. L. REV. 1089, 1105 (1972), for the
origin of the terms.
23. See id. See Robert P. Merges, Of Property Rules, Coase, and Intellectual Prop-
erty, 94 COLUM. L. REV. 2655 (1994), for a discussion of property and liability rules in
the context of intellectual property. In this context, Paul Goldstein refers to problems
associated with the right to exclude as “the problem of inappropriability” and problems
regarding the right to access as “the problem of indivisibility.” Paul Goldstein, Com-
ments on a Manifesto Concerning the Legal Protection of Computer Programs, 94
COLUM. L. REV. 2573, 2574 (1994) [hereinafter Goldstein I].
25. Id. § 102 (stating that “copyright protection subsists . . . in original works of
authorship fixed in any tangible medium of expression”). According to the statutory
notes, “tangible medium of expression” is independent of the form, manner, or medium
of fixation and of whether it is capable of perception, directly or by means of any ma-
chine or device “now known or later developed.” The meaning of tangible medium of
expression is important for understanding whether computer object codes or codes em-
bedded on Read Only Memory (“ROM”) can receive copyright protection. See Apple
Computer Inc. v. Franklin Computer Corp., 714 F.2d 1240 (3d Cir. 1983) (holding that
object codes and codes embedded on ROM are copyrightable).
the copyright owner lies in a court’s authority to issue injunctions against the infringer and to impose damages for lost profits. This protection corresponds to a property rule.\textsuperscript{26} In certain cases, however, a third party can have access to the copyrighted work and pay the owner for use.\textsuperscript{27} For example, cable television operators can transmit copyrighted works without the consent of the copyright owner, as long as the operator compensates the owner for use.\textsuperscript{28} This remedy, referred to as a “compulsory license,”\textsuperscript{29} is granted for four categories of copyrighted works—cable broadcasts, musical compositions, public broadcasting, and jukeboxes—and it corresponds to liability rule protection for the copyright owner.\textsuperscript{30} In contrast, the Lanham Act\textsuperscript{31} provides no compulsory licenses for trademarks. Instead, the Lanham Act provides that the trademark owner can obtain an injunction against an infringing use and recover an accounting for profits from third parties.\textsuperscript{32}

One of the incidents of property ownership is the ability to transfer rights voluntarily to other parties.\textsuperscript{33} Copyrights, and to a more limited extent trademarks, can be licensed to third parties whose rights in the copyright or trademark are determined solely by the terms of the license.\textsuperscript{34} A licensor of a trademark or copy-
right can protect his rights against a licensee primarily through property rules. If the licensee makes use of the protected work in a way that is inconsistent with the license, this use would be the basis for an infringement action.\textsuperscript{35} If the licensor breaches, more likely than not, the licensee’s rights in the license are protected by a liability rule, that is, a suit for damages.

Just as a copyright or trademark license grants rights to third parties, secured credit grants rights in the assets of a debtor to a secured creditor.\textsuperscript{36} Once a debtor has obtained a loan from a creditor secured by collateral, the debtor is free to use the same collateral as security for other loans, and to continue using the collateral in his business.\textsuperscript{37} The debtor does not lose the incidents of owner-
ship, except for granting the secured creditor the right to attach the collateral in the case of default. The rights of the secured creditor vis-à-vis the debtor are purely contractual ones, protected by a property rule, i.e., the right to obtain the property from the debtor in case of default. The secured creditor, however, also obtains rights vis-à-vis other secured creditors. Specifically, under article 9, if the secured creditor can perfect or file his rights in the collateral before other creditors with interests in the same collateral, then the secured creditor obtains priority in the settlement of the debt. This priority can arise in state court proceedings against the debtor or in federal bankruptcy proceedings in which the

section 9-302(1) of the U.C.C., excludes money and instruments, which includes a negotiable instrument or “any other writing that evidences a right to the payment of money” other than a security interest or chattel paper, from the available types of collateral. U.C.C. § 9-302(1) (1995). Money and instruments can be perfected only through possession by the secured creditor. See id. § 9-304(1). Although possession is always a permissive means of perfecting a security interest for a range of collateral under section 9-305, the most common way to perfect is through filing.

38. The secured party’s rights to collect on the debt, to take possession of the collateral, and to dispose of the collateral upon possession are provided in the U.C.C. Id. §§ 9-502, 9-503, 9-504. “Unless otherwise agreed a secured party has on default the right to take possession of the collateral. In taking possession a secured party may proceed without judicial process if this can be done without breach of the peace or may proceed by action.” Id. § 9-503.

39. There is a conceptual problem as to whether this right constitutes a property rule or liability rule. If the creditor obtains the full value of the debt by taking possession of the collateral, then the creditor has essentially obtained specific performance on the debt. The remedy can be described as a property rule protecting the creditor’s right to exclude the debtor from use of the collateral upon default. If the creditor does not obtain full value, however, he may still have deficiency rights against the debtor. In this case, the creditor arguably has not obtained full property rule protection for the debt obligation. The problem is exacerbated because disposing of the collateral through a judicial sale or auction may constitute a waiver of deficiency rights. See id. § 9-504(4) (stating that disposition discharges security interests). In the last two scenarios, the remedy can be seen as a type of Spur injunction, in which a party gets to exercise his rights but must compensate the other party for any harm caused. Spur Industries, Inc. v. Del E. Webb Dev. Co., 494 P.2d 700 (Ariz. 1972). In this case, the debtor is allowed to default on the debt but can pay the secured creditor an amount less than the full value of the obligation. See Saul Levmore, Love it or Leave it: Property Rules, Liability Rules, and Exclusivity of Remedies in Partnership and Marriage, 58 LAW & CONTEMPS. PROBS. 221 (1995), Shubha Ghosh, Property Rules, Liability Rules, and Termination Rights, 75 OR. L. REV. (forthcoming 1998).

40. See U.C.C. § 9-504.

41. See id. § 9-301.
debtor’s obligations are liquidated or restructured. Compared to other secured creditors with lower priority, the secured creditor’s rights in the collateral are protected by a property rule.

Once the laws of copyright, trademark, and secured credit are viewed in terms of property rules and liability rules, it is easier to see the sources of conflict. Nevertheless, current proposals to reconcile the intellectual property laws with the law of secured credit are flawed because they overlook the critical inconsistencies between those regimes. The shortcomings of the reform proposals reflect fundamental differences between the views of intellectual property optimists, who believe in broad protections for creative works, and intellectual property pessimists, who believe in minimal protections for creators.

This Article approaches the conflict from the perspective of an intellectual property optimist, advocating more protection for intellectual property owners and less for creditors and licensees. Part I sets forth the background of intellectual property and secured credit. Part II suggests ways to allocate property rights between secured creditors and licensors or licensees of technology. Because a system of secured credit protection is truly tested by its operation in bankruptcy, Part III analyzes bankruptcy problems arising from the use of copyrights and trademarks as collateral. Part IV, which details the differences between intellectual property optimists and intellectual property pessimists, reveals how the Bankruptcy Code and article 9 of the U.C.C. currently undermine important and substantive interests of copyright and trademark. Part

44. See PAUL GOLDSTEIN, COPYRIGHT’S HIGHWAY: THE LAW AND LORE OF COPYRIGHT FROM GUTENBERG TO THE CELESTIAL JUKEBOX 16-21 (1994) [hereinafter COPYRIGHT’S HIGHWAY] (distinguishing between copyright optimists who argue that “there is no harm in extending copyright to encompass the economically valuable uses that may fill copyright’s cup” and copyright pessimists who ask “[i]f a copyrighted work can be so easily viewed or copied, . . . what harm is there in excusing these additional uses from copyright liability”). Although Professor Goldstein distinguishes between “copyright optimists” and “copyright pessimists,” this Article generalizes his distinction to encompass trademark as well as copyright. See discussion infra Part IV.

The author adopts the perspective of the intellectual property optimist solely for the purpose of grounding the analysis of this Article.
V critiques several reform proposals, including reforms aimed at security interests in copyright, trademark, and computer software licensing. This Article concludes that the perspective of the intellectual property optimist will generate the most effective reform proposals to reconcile the law of intellectual property with the law of secured credit.

I. BACKGROUND: INTELLECTUAL PROPERTY AND SECURED CREDIT

Intellectual property law covers three broad areas under federal law: copyrights, trademarks, and patents, and covers several incidental areas under state law, such as trade secret law and unfair competition law. The law of secured credit encompasses both state and federal law. The primary body of state law is article 9 of the U.C.C., which governs the rights of secured creditors against the debtor and other creditors. Although article 9 has its own provisions for enforcement, the biggest implications of article 9 are for the federal law of bankruptcy, in which the legal disputes between the creditors and the debtor are settled. This part begins by providing a quick introduction to the respective property regimes of intellectual property and secured credit law. Next, it discusses whether the two regimes are consistent; first by employing a hypothetical example to show the two systems at work, and second, by highlighting and categorizing the conflicts between the two regimes.

A. Two Property Rights Regimes: Intellectual Property Law and Secured Credit Law

Intellectual property law and the law of secured credit present

49. See, e.g., N.Y. GEN. BUS. LAW § 360-1 (McKinney 1997) (providing for injunctive relief against “injury to business reputation” and against “dilution of the distinctive quality of a mark”).
51. Id. § 9-201.
52. Id. §§ 9-501-9-507.
two different property rights regimes with different goals and mechanisms. Intellectual property law protects creative efforts and allows creators to exclude others from using the product of such efforts.\(^53\) Copyright protects “original works of authorship” and gives the author the right to exclude others from using, copying, or compiling the work.\(^54\) Unauthorized users or copiers of the work can be enjoined and sued for damages, usually measured by lost profits.\(^55\) Trademark law, on the other hand, protects the trademark holder’s right to use a mark to designate origin and signal quality on products traded through interstate commerce.\(^56\)

Although distinct bodies of law, copyright and trademark laws may overlap with respect to subject matter.\(^57\) For example, copyright law would protect the underlying computer code in a multimedia compact disk game, and trademark law would protect the trade or brand name of the product. In this way, different aspects of the same product would be protected by both trademark and copyright law.

The law of secured credit also protects various dimensions of a product. Whereas intellectual property law protects the fruits of creative efforts, the state law of federal credit protect the interests that creditors may have in a particular property against claims of

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53. See Copyright’s Highway, supra note 44, at 9-11.

54. See discussion supra note 25 and accompanying text (describing copyright protection).

55. See discussion supra note 26 (providing statutory provisions relating to copyright infringement).

56. See supra note 31 (citing to the Lanham Act).

57. The subject matter of copyrights often overlaps with that of trademarks. For example, “[w]hen the Walt Disney Company gets a court order stopping the publication of unauthorized cartoons featuring Mickey Mouse, it is not only because Mickey Mouse is a trademark, indicating Disney as its source, but also because Disney owns the copyright in the Mickey Mouse image.” Copyright’s Highway, supra note 44, at 10. Copyright law and trademark law also overlap in the area of gray market protection:

If gray marketeers are allegedly violating the goodwill of and investment in distinctive trademarks, then trademark law is arguably the more appropriate basis for the claim; copyright law is intended to protect creative efforts. This argument, however, is too formalistic. The process of creating distinctive marks is as much a creative effort as writing a novel or painting a picture.

the debtor and claims by other creditors. For example, the creator of a multimedia game can use the copyrights and trademark that he owns in his creation as collateral to obtain credit to finance his creation. Secured credit creates a split ownership situation in which the creditor is given a property interest in the debtor’s assets. In this way, the law carves up various dimensions of a product and protects interests that different groups might have in the same product.

B. Are the Two Property Rights Regimes Consistent?

The difficult question is whether the various protections afforded by intellectual property law and the law of secured credit are consistent. To see the problem, consider the following example. Merges plans to develop and market computer software under the trademark “DiskCo.” He has a prototype of the software that he has privately tested, but needs to fund his broader project of manufacturing, marketing, and distributing the product. In order to raise the necessary capital, Merges obtains a loan from Nimmer and secures the loan through Merges’s tangible property, such as office furniture, through Merges’s interests in accounts receivable, and through Merges’s intellectual property rights in both the software program and the trademark. This section analyzes how various protections of intellectual property law and secured credit law play out in this situation. First, this section shows what rights exist under the two property systems, and second, it examines conflicts

58. See U.C.C. § 9-201.
59. See Haemmerli, supra note 11.
60. See Harris & Mooney, supra note 36, at 2037-42. The “split ownership” situation in the secured credit context is the reason that security interests were suspect at common law. A grant of a security interest without corresponding transfer of possession was viewed as a fraudulent conveyance. See Benedict v. Ratner, 268 U.S. 353 (1925) (invalidating security interest because creditor allowed debtor dominion and control over assets and proceeds). The rule of Benedict v. Ratner has been expressly rejected in section 9-205 of the U.C.C., which states that “a security interest is not invalid or fraudulent against creditors by reason of liberty in the debtor to use, commingle, or dispose of all or part of the collateral.” U.C.C. § 9-205; see also Douglas G. Baird & Thomas H. Jackson, Possession and Ownership: An Examination of the Scope of Article 9, 35 STAN. L. REV. 175, 212 (1983) (stating that “the law of secured transactions has ordered itself around” the principle that “[p]ossession of personal property is the best evidence of its ownership”).
that occur when these two systems interact.

1. The Two Property Rights Regimes At Work

As an initial matter, Merges obtains the protection of copyright law when the work is placed in a tangible medium of expression.\(^1\) Therefore, as soon as Merges encodes the program on a disk electronically, Merges will obtain copyright protection for his work. Nevertheless, in order to secure his rights to sue, Merges must register his copyright with the Copyright Office.\(^2\)

Merges would also like to obtain trademark protection for the mark “DiskCo.” Obtaining trademark protection, however, is more complicated than acquiring copyright protection.\(^3\) First, Merges must actually use or intend to use the mark in commerce; for example, by making some initial sales of the program with the mark.\(^4\) Second, Merges must submit an application to the Patent and Trademark Office (“P.T.O.”) to review the mark.\(^5\) The P.T.O. will grant Merges’s application if the mark is distinctive, not otherwise duplicative, and does not infringe on existing marks.\(^6\) Once the P.T.O. grants Merges a trademark in “DiskCo,” Merges is allowed to use the mark of his product in the specific geographic area of distribution.\(^7\) After registering the mark with the P.T.O., Merges will be allowed to sue for infringing uses by other distribu-

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62. According to one commentator, “[r]egistration is not a condition of copyright protection, and a copyright owner may obtain registration for her work at any time during the copyright term.” COPYRIGHT’S HIGHWAY, supra note 44, at 549. Registration is a prerequisite to sue for statutory damages and attorney’s fees. See 17 U.S.C. § 412. Registration is also a requirement for filing a copyright infringement action against works originating in the United States. See id. § 411(a).
64. See 15 U.S.C. § 1051. “Use in commerce” means the “bona fide use of a mark in the ordinary course of trade, and not merely to reserve a right in a mark.” Id. § 1127.
65. See id. § 1051 (detailing application process); see also COPYRIGHT’S HIGHWAY, supra note 44, at 202-04 (describing the application process).
tors. If the P.T.O. fails to grant the application, Merges can still use the mark, assuming that it does not infringe on other marks, and has rights under state and federal unfair competition law to sue for deceptive or misleading uses of the mark.⁶⁸

The rights of Nimmer, Merges’s creditor, in the secured loan extended to Merges are protected by the law of secured credit. Initially, Nimmer must secure his rights against Merges through a contract that states the amount of the loan, the conditions of repayment, and the type of collateral used to secure the loan.⁶⁹ The relationship between Merges and Nimmer is governed wholly by the common law of contracts,⁷⁰ although article 9 of the U.C.C. specifies the types of items that Merges can use as collateral and the manner in which the collateral needs to be described to create a valid security interest.⁷¹

Nimmer, however, also needs to secure his rights in Merges’s assets against the rest of the world. Merges is perfectly free to borrow more money from other creditors and even secure the loans with the same assets used to secure the loan from Nimmer.⁷² In order to protect his rights, Nimmer must perfect his security interest in Merges’s assets by filing a financing statement at the state level.⁷³ This filing, listed under Merges’s name, describes the nature of Nimmer’s security interest and sets the date to establish Nimmer’s priority in case there is a conflict with other creditors, especially those who have also taken a security interest in the same

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⁶⁸. The state law claims include passing off, dilution, and misappropriation. See COPYRIGHT’S HIGHWAY, supra note 44, at 55-112; see also 15 U.S.C. § 1125 (governing federal claims).

⁶⁹. Article 9 of the U.C.C. “applies to security interests created by contract, including pledge, assignment, chattel mortgage, chattel trust, trust [and] deed . . . .” U.C.C. § 9-102(2) (1995). A security interest is created through a security agreement between the debtor and the creditor. The security agreement is effective upon (1) the signing of an agreement that contains a description of the collateral in which the debtor has rights, and (2) value is given to the debtor. See id. § 9-203(1).

⁷⁰. See generally Delaware v. New York, 507 U.S. 490, 503 (stating that the primary rule regarding intangible personal property, such as debts, flowed from the common law concept of mobilia sequuntur personam).

⁷¹. See U.C.C. §§ 9-203, 9-204, 9-205.

⁷². See id. § 9-205.

⁷³. This is usually done with the Secretary of State. See id. § 9-402.
Interestingly enough, there is a concrete parallel between the system of property rights protection under copyright and trademark laws and under the state law of secured credit. Each system has its own method of registration whereby property rights are publicized to the rest of the world. Each requires a description of the underlying property interest. Unlike the state system of registering security interests, the federal system of registering intellectual property rights in trademarks requires review by an administrative board. Registration of copyrights involves far less review than registration of trademarks, but more so than filing a security interest under state law. A state filing is done under the debtor’s name in order to facilitate the identification of the debtor by other creditors, however, a federal filing is registered under the particular property that is protected.

Just as registration of copyrights and trademarks creates rights to sue for infringement under federal law, filing a security interest secures rights in legal battles between the debtor and other creditors under state law. At the state level, a secured creditor can sue a defaulting debtor and attach the underlying collateral described in the financing statement. The right to attach usually means the right to sell the collateral in a public sale for the benefit of the debtor, in order to recover proceeds on the debt.

Filing a security interest has even greater implications at the federal level. If the debtor is forced into bankruptcy, a secured creditor has priority in the liquidation of claims over other credi-

74. See id.
76. The registration and contestability proceedings are reviewed by the P.T.O. and are under the jurisdiction of the Trademark Trial and Appeal Board. See 15 U.S.C. §§ 1063-1070.
78. See U.C.C. §§ 9-402, 9-403.
79. See id. §§ 9-402(3), 9-403(4).
82. See U.C.C. §§ 9-203, 9-503, 9-504.
tors.83 So, if Merges enters into bankruptcy and Nimmer has made the appropriate state filings, Nimmer’s claims over Merges’s collateral, which would be a part of Merges’s estate in bankruptcy, will obtain priority over other claims. Contrast this with the fate of unsecured creditors, those who extended loans without obtaining a security interest in collateral, or secured creditors who failed to file correctly; both receive only a pro-rata share of the funds remaining in the debtor’s estate after all secured claims and other priority claims are settled.84 Thus, the cost of not filing is the loss of recovery on the underlying debt.85

2. Conflicts Between the Two Property Rights Regimes

The laws of copyright and trademark and the law of secured credit provide complementary schemes to protect the rights of the debtor-entrepreneur and the creditor. In our hypothetical, however, some conflicts become apparent as we contrast the different types of collateral in which Nimmer has taken a security interest. This section divides the respective obstacles into recording, fuzziness, and Bankruptcy Code problems to facilitate an understanding of the arising conflicts.

a. Recording Problems

Nimmer’s security interests are in three types of property: personal property (equipment), intangible property (accounts receivable), and intellectual property (copyrights and trademarks). To perfect his interests in each of these assets, Nimmer must file a complete and accurate financing statement covering the respective properties.86 The first difficult question is where to file. Article 9 provides that security interests in equipment and intangibles can be perfected through an appropriate state filing.87 Intangibles, for the purpose of article 9, include not only accounts receivables but also intellectual property.88 Article 9 provides that when property is

83. See id. §§ 9-301, 9-306(4).
84. See id. §§ 9-301, 9-401.
85. See id. § 9-301.
86. See id. § 9-302(1).
87. See id. § 9-401 (laying out alternative schemes for state filings).
88. Id. § 9-106.
governed by federal law, federal law applies to the perfection of security interests. 89 In other words, article 9 incorporates applicable federal law. 90 Under section 205 of the Copyright Act, 91 all transfers and assignments of copyrights may be recorded, 92 and section 205 contains its own provisions for priority disputes between assignees and transferees of the same copyright. 93 Section 10 of the Lanham Act 94 has a similar provision for the recording of assignments of trademarks and the resolution of priority disputes among assignees. 95

Determining whether a security interest is a transfer or an assignment is essential to understanding the application of the law. The distinction between transfer and assignment rests on whether title in the underlying property passes. If title does not pass, then the interest is transferred; 96 if title does pass, the interest is assigned. 97 Security interests are transfers and not assignments, 98 therefore, under a strict reading of the Copyright Act and the Lanham Act, the security interest in the copyright must be recorded at the federal level and the security interest in the trademark need not be. 99

In any case, the complication introduced by the Copyright Act does not, on its surface, severely undermine the manner in which the law protects secured creditors—the wrinkle added is the need

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89. According to its terms, article 9 “does not apply . . . to a security interest subject to any statute of the United States, to the extent that such statute governs the rights of parties to and third parties affected by transactions in particular types of property . . . .” Id. § 9-104(a).
90. See id. § 9-104, cmt. 1.
92. See id. § 205(a).
93. See id. § 205(d).
95. See id.
96. A “transfer” is defined as “[a]n act of the parties, or of the law, by which the title to property is conveyed from one person to another.” BLACKS LAW DICTIONARY 1497 (6th ed. 1990).
98. See Roman Cleanser, 43 B.R. at 945.
for an additional filing. This wrinkle, however, introduces several elements of uncertainty into the process of perfecting security interests. The first issue is whether a dual filing, rather than a single filing with the Copyright Office, is required to perfect one’s interest. The second element of uncertainty concerns conflicts between the Copyright Act and the Lanham Act, when each statute arguably protects the intellectual property at issue. The third problem is in regard to determining which priority rules should apply in the context of a dual filing—a choice between the state rules and those found in the Copyright Act. The fourth issue arises because, under state law, the filing of a financing statement lapses unless the creditor files a continuation statement, and no similar provision exists under the Copyright Act. Thus, it is unclear which rule governs the interests of a secured creditor. The resolution of these issues has been uncertain and most practitioners have adopted a “belt and suspenders” approach, thereby filing all intellectual property interests under both the state and the federal systems, while hoping that the security interest can obtain the fullest protection.

The conflicts arising from the appropriate place to file are mostly technical. There are, however, more deeply conceptual conflicts that arise from the use of trademarks and copyrights as collateral. The key to a security interest in property is the separation of ownership and possession.102 Even though the debtor may physically own the collateral, the debtor is not the full owner be-

100. According to the court in Roman Cleanser:
Commentators who address the question admit that 15 U.S.C. § 1060 presents problems of construction and does not clearly establish a method for perfecting a security interest in trademarks. . . . Not only is there a lack of agreement as to whether section 1060 provides for the recordation of security interests with respect to trademarks[,] but, additionally, the commentators who assume that a Lanham Act filing is required, do not agree as to what documents are to be filed. Roman Cleanser, 43 B.R. at 945.


cause the secured creditor has the right to attach the collateral in the case of default.\footnote{103}

In the classic case of Benedict v Ratner,\footnote{104} the separation of ownership and possession created by secured credit troubled the court to such an extent that the court held the contractual relationship between creditor and debtor, which created the security interest, fraudulent and void.\footnote{105} The problem was largely one of notice. According to the court, if possession did not equal full ownership, creditors would be susceptible to great harm.\footnote{106}

The system of recording security interests under article 9 was designed to resolve this issue by creating a means by which the creditor can publicize his interests in the debtor’s property, just as the system of recording title in real property publicizes the owner’s interest to the rest of the world.\footnote{107} To the extent that copyright and trademark recordation systems conflict, the goal of providing notice to other secured creditors is undermined and the secured transaction takes on the character of the “secret lien,”\footnote{108} which was struck down in Benedict v. Ratner.\footnote{109}

b. Fuzziness Problems

A system of recording security interests can solve only part of the problems created by the use of intellectual property. Rights in tangible and real property can be ascertained readily through a re-

\footnote{104} See discussion supra note 60 (describing the problem in Benedict v. Ratner).
\footnote{105} See Vaccaro, supra note 102, at 364-65.
\footnote{106} See id. at 362-64.
cording system. With real property, rights can be divided among only three dimensions: time, space, and person. Tangible property, such as equipment, can be similarly divided through the leasing of the property to third parties. Intangible property can be divided in more complicated ways, especially through securitization; accounts receivable can be traded and divided up among potential investors.

Intellectual property rights, in a similar vein, can be divided infinitely. Ownership of a copyright entitles the owner to have exclusive right to reproduce, adapt, publish, perform, and display the copyrighted work. Ownership of a trademark entitles the owner to use the protected mark to designate products for sale within a particular geographic area. Copyright and trademark owners can subdivide and license off their rights in many more ways than holders of tangible or intangible properties. Furthermore, the extent of protection accorded to copyrights and trademarks is potentially much greater than that accorded to other property.

In addition, the boundaries of copyright and trademark are fuzzy. The owner of a trademark can enjoin the use of a mark that is similar to his own mark and potentially deceptive. Similarly, the owner of a copyright can enjoin and obtain recovery not only for direct copies of the work, but also for copies of work that could

113. It is impossible to make this comparison in a quantitative, precise way. Consequently, the boundaries of copyright and trademark are less clear than those of real property and other intangible property. "Some objects of property claims indeed seem to resist clear demarcations altogether." Carol M. Rose, Possession as the Origin of Property, in Property & Persuasion: Essays on the History, Theory, and Rhetoric of Ownership 17 (1994) (demonstrating limits on principle of possession as defining ownership of a property right); see also Robert Cooter & Thomas Ulen, Law and Economics 125-128 (1996) (illustrating difficulties in drawing boundaries of copyright and trademark).
be derived from the copyrighted material. Although indistinct boundaries make the sweep of copyright and trademark protection quite broad, the fuzziness also creates uncertainty as to what is, in fact, protected. For example, a secured creditor must determine how to actually value the intellectual property in which he will obtain an interest.116

c. Bankruptcy Code Problems

If the fuzziness created by intellectual property were solely one of certainty and notice, for the purposes of valuation and publicity, the resolution would be a more extensive, albeit more complicated, system of recordation. Such a system would resolve not only conflicts between different secured creditors, but also disputes between creditors and all other individuals who have an interest in the intellectual property via licenses or assignments.117 A more elaborate system of recordation, however, would not resolve the problems created by the Bankruptcy Code.

Grasping the problems engendered by specific provisions of the Bankruptcy Code is impossible without comprehending the Bankruptcy Code as a whole. To aid understanding, this part provides a brief overview of the Bankruptcy Code. In addition, this part explores section 365, which provides the most difficulties for the purposes of this Article.

i. Overview of the Bankruptcy Code

Federal bankruptcy law provides a procedure through which a debtor can obtain a “fresh start,” either through the liquidation of claims or through reorganization.118 Within bankruptcy, secured

116. See Haemmerli, supra note 11, at 1651-53; see also In re Specialty Foods of Pittsburgh, Inc., 91 B.R. 364, 372-73 (Bankr. W.D. Pa. 1988) (rejecting the creditor’s challenge over the value of assets because of the rule that the best offer obtainable by the trustee for the debtor’s property is “conclusive on the issue of value”).

117. See Haemmerli, supra note 11, at 1721-52 (describing various reform proposals); Weinberg & Woodward, supra note 109, at 79-108 (same).

creditors who have perfected their interests obtain priority, in the
liquidation of claims, over other secured creditors who have failed
to perfect and all unsecured creditors.\textsuperscript{119} Perfected secured credi-
tors also receive priority in bankruptcy reorganizations.\textsuperscript{120} Before
either liquidation or reorganization occurs, however, the debtor,
through the trustee, must assemble the bankruptcy estate.\textsuperscript{121}

The bankruptcy trustee has extensive powers to affect the as-
ssembly of the debtor’s estate, including (1) the “strong arm power”
to exercise state law rights against third parties that have recovered
from the estate, prior to the filing of the bankruptcy petition;\textsuperscript{122} (2)
the power to recover preferential payments made to third parties,
prior to the filing of the bankruptcy petition;\textsuperscript{123} and (3) the power
to recover payments made by the debtor to third parties, prior to
bankruptcy, as fraudulent conveyances.\textsuperscript{124} Coextensive with these
powers is the right of the debtor to assume or reject outstanding
obligations existing at the time of bankruptcy in executory con-
tacts.\textsuperscript{125} Under section 365 of the Bankruptcy Code, the trustee
can elect, at his discretion, either to maintain ongoing contractual
obligations through bankruptcy or to breach the obligations giving
rise to claims in bankruptcy by a creditor.\textsuperscript{126} The implication is

law often conflicts with preexisting federal and state laws.
\textsuperscript{120} See id. §§ 1123-1132 (stating priority rules for reorganizations).
\textsuperscript{121} See ROBERT L. JORDAN & WILLIAM D. WARREN, BANKRUPTCY 32-33 (1993)
(ending that assembly of debtor’s estate serves two purposes, namely, determination
of liquidation under Chapter 7 and scope of automatic stay under section 362); see also
\textsuperscript{122} See 11 U.S.C. § 544(a) (providing strong arm powers of trustee, and giving
trustee powers of judicial lien creditor to avoid any transfer of property of debtor).
\textsuperscript{123} See id. §§ 547(b), 547(c).
\textsuperscript{124} See id. § 548.
\textsuperscript{125} See id. § 365. Even though the provision pertaining to executory contracts is
contained in the section of the Bankruptcy Code covering “Case Administration,” con-
ceptually, the Bankruptcy Code’s treatment of executory contracts is better seen as an
issue pertaining to the assembly of the debtor’s estate. See DOUGLAS G. BAIRD ET AL.,
GAME THEORY AND THE LAW 133 (1994) [hereinafter GAME THEORY] (noting parallel be-
tween sections 365 and 541(c)); Jay Lawrence Westbrook, A Functional Analysis of
Executory Contracts, 74 MINN. L. REV. 227, 247-50 (1989) (arguing that trustee’s powers
under section 365 are meant to be exercised for benefit of estate in manner analogous to
trustee’s powers under section 541).
\textsuperscript{126} See 11 U.S.C. § 365.
that the debtor has the power to continue performing contractual obligations that are profitable to perform or to liquidate his obligations for a reduced amount under bankruptcy.127

From a property rights perspective, the Bankruptcy Code protects the debtor’s contractual rights through a property rule, while the non-bankruptcy law would only accord liability rule protection.128 The debtor in bankruptcy can elect to maintain pre-bankruptcy contractual relationships, even if the contract is not profitable from the perspective of the non-debtor contracting party. Although the non-debtor party can breach the contract and provide the debtor with a legal claim to add to the debtor’s estate, the debtor can elect to breach and liquidate his claims to the non-debtor as the debtor would all other obligations to unsecured creditors.129 Bankruptcy allows the debtor to breach at reduced cost and if the debtor’s claims are substantial, as they often will be, the debtor can effectively “take” from the non-debtor party without paying.130

ii. Section 365 of the Bankruptcy Code

In the late 1980s, section 365 created a host of problems that led to amendment of the section.131 The foremost problem arose in

127. See GAME THEORY, supra note 125, at 131-37; Westbrook, supra note 125, at 263-75.

128. The bargaining game between creditors and debtors is complex, and the possibility to hold up or cram down reorganization plans may alter the manner in which rights are protected within bankruptcy. For discussion at this point, this Article adopts the simple application of the bankruptcy rules independent of how the rules affect strategies within bankruptcy. See GAME THEORY, supra note 125, at 232-34, for a discussion of a richer and more detailed bargaining game.

129. See Westbrook, supra note 125, at 252-55.

130. See generally id. at 257 (describing the debtor’s right to breach contracts).

According to one commentator:

Even in a case in which the bankruptcy court’s estimate might give the Other Party a damage claim that is undercompensatory, denial of specific relief is the fairest result. Because bankruptcy almost always yields very low recoveries for all creditors, the Other Party’s understated claim probably will result in a distribution closer to equality with the other creditors than would granting specific performance.

Id.

131. The controversy was created by Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043 (4th Cir. 1985) (holding that debtor-licensor of intellectual
the context of intellectual property licenses. If the debtor was the licensor of software and entered into bankruptcy, the debtor could, under the prior version of section 365, elect not to continue the license and enjoin the licensee from use of the software. Although the licensee would have a claim for breach of the license, the claim would be an unsecured one and would not result in full recovery for the licensee. Furthermore, the licensee could not enjoin the licensor from breaching the agreement and is unable to continue using the software because of the automatic stay provisions of the Bankruptcy Code. As a result, licensees of intellectual property assumed the risk of losing their right to use the licensed technology.

In response to the complaints of software licensees, Congress resolved this problem by amending section 365(a) through section 365(n), which gave the licensee the right to elect continued use of the intellectual property or a claim in bankruptcy, in the event of a breach by the licensor. Although the provisions of section 365(n) solved some of the problems faced by intellectual property licensees, two gaps remained: (1) the treatment of licensors should the licensee enter bankruptcy, and (2) the exclusion of trademarks from the definition of intellectual property under the Bankruptcy Code.


133. See Brinson, supra note 131; Moy, supra note 131.
134. See Westbrook, supra note 125.
Section 365 converts liability rules under non-bankruptcy law into property rules in bankruptcy. In the context of a bankruptcy filing by the licensor of intellectual property, liability rule protection for the licensee is converted into property rule protection. If the licensee files bankruptcy, however, the licensee obtains full property rule protection for rights under the license and the licensor receives almost no protection.

The conflict in property rights regimes is exacerbated by the introduction of secured credit. Suppose Merges owns and operates a bookstore chain called “NoBorders.” Merges franchises the operation to Nimmer. The franchise agreement includes rights in the use of the trademark “NoBorders” and rights to use specially designed inventory-software in which Merges owns the copyright. Nimmer uses a secured loan from Bank to finance the purchase of the franchise. In return, Bank takes a security interest in the trademark and the copyrighted software, and properly perfects its interest.

Merges files for bankruptcy and, under section 365, elects to reject the license. Nimmer exercises his section 365(n) election to continue use of the software. Nimmer, nevertheless, cannot make such an election with regard to the trademark because the Bankruptcy Code does not include trademarks in the definition of intellectual property under section 101(35A). Although Nimmer will have a claim for breach against Merges for Merges’s rejection of the trademark license, the claim will only be an unsecured one. Furthermore, it is unclear how Bank’s security interest in the trademark should be treated under the law. Uncertainty exists as to whether Bank has lost its interest because Bank’s rights were purely derived from Nimmer’s license with Merges.138 Or, per-

137. Section 365(n) applies only when the licensor of intellectual property is the bankrupt party. See Brinson, supra note 131 (describing inadequacies of section 365(n) where licensee is the bankrupt party). The Bankruptcy Code defines “intellectual property” to include “(A) trade secret; (B) invention, process, design, or plant protected under Title 35; (C) patent application; (D) plant variety; (E) work of authorship protected under title 17; or (F) mask work protected under Chapter 9 of title 17.” 11 U.S.C. § 101(56). Interestingly enough, trademarks are excluded from the list.

138. If the bank were a creditor of Merges, the bankrupt party, it could obtain ade-
haps Bank’s interest will carry through to the damages recovered by Nimmer through the bankruptcy liquidation.139

The problems for secured creditors, like Bank, are worse if the licensee Nimmer enters bankruptcy. Because section 365(n) applies only to bankruptcy petitions filed by the licensor,140 section 365(a) will apply,141 allowing Nimmer to reject unilaterally the franchising agreement, including both the copyright and the trademark licenses. The open question is the effect of the decision to reject on Bank’s security interest. Bank may be able to enjoin Nimmer’s rejection because it would impair Bank’s interest in bankruptcy.142 If Bank can enjoin Nimmer, Bank’s status with regards to Merges is unclear. Bank may be able to liquidate its claims on Nimmer’s debt to some degree. If Bank cannot enjoin Nimmer, however, Bank’s status with regards to Merges will also be unclear. Although Merges would have a claim as an unsecured creditor should Nimmer choose to reject the contract, Bank’s status is unclear once Nimmer rejects the licenses that served as the source for Bank’s security interest.

The primary problem is the conflict between property rights

quate protection for its interests under section 362(d)(1), which allows the court to grant relief from the automatic stay. Id. § 362(d)(1). This provision, however, only applies to “a party in interest.” Id. Because the bank is a creditor of Nimmer in this hypothetical, it most likely will not be able to obtain adequate protection.

139. The result will hinge upon the language of the security agreement. The facts of this hypothetical are similar to those of In re Specialty Foods of Pittsburgh, 98 B.R. 734 (1989). In Specialty Foods, the secured creditor tried to assert its rights in the licensee-debtor’s “rights to payments” stemming from “general intangibles.” Id. The court held that the terms of the security agreement did not give the creditor any rights in the debtor’s license of a mark from the trademark licensor-owner because the creditor’s rights related only to “rights to payments.” Id. Because the licensee-debtor had an obligation to make payments under the license, and no right to payments under the license, the creditor did not have a security interest in the license. If the bank in the Nimmer-Merges hypothetical had secured rights in Nimmer’s rights to payment stemming from the trademark license, the bank would probably have rights in any damage claims that Nimmer would have against Merges for breach. The bank could protect its rights better by stating its rights in the trademark license more broadly, for example, by stating in the security agreement that its rights extended to “all Nimmer’s rights under any trademark.” See Clark, supra note 109, ¶ 1.08[1][G].

140. 11 U.S.C. § 365(n)(1).
141. Id.
142. As a creditor of the debtor Nimmer, the bank is a party in interest and can obtain adequate protection under section 362(d)(1). Id. § 362(d)(1).
systems comprised of property rules and those comprised of liability rules. In a bankruptcy petition filed by the licensor, the licensee has property rule protection against the licensor, although the secured creditor of the licensee has only liability rule protection against the licensee. It is uncertain what rights the secured creditor would have with regards to the licensor and how these rights would be protected. Although the licensee has the right to exclude the licensor from the intellectual property, if the licensor files for bankruptcy, the secured creditor has the right to take the licensee’s property and pay for it. The problem is that the licensee’s rights are derivative of the licensor’s rights and the licensee has greater protection of its rights than the secured creditor. Questions arise regarding the level of protection that should be afforded to secured creditors and the proper means of providing such protection. Clearly, refining the system of recordation is not adequate.

II. THE CHOICE BETWEEN PROPERTY RULES AND LIABILITY RULES AS APPLIED TO ATTACHMENT, PERFECTION, AND PRIORITY

More than theoretical analysis informs the decision of whether property or liability rule protection is preferable, as transaction costs bear a significant impact on all of the models. Further wrinkles are added when one considers trademarks and copyrights used as collateral. This part explores the effect of transaction costs within property regime protections and considers the problems that inhere when intellectual property is used as collateral.

A. Analyzing Property Regimes From a Transaction Costs Perspective

The protection of property rights is determined in many instances by politics rather than economics.143 For example, the compulsory license scheme under the Copyright Act for musical compositions, jukeboxes, cable television broadcasts, and public

143. See Daniel A. Farber & Philip P. Frickey, Law and Public Choice 1-11 (1991) (arguing that legislative enactments, whether regulatory or deregulatory, can be explained by competition among political interest groups); see also Gary D. Libecap, Contracting for Property Rights 1-9 (1989) (maintaining that property right systems result from particular institutional arrangements, and that contracting among rational parties mitigates costs stemming from poor institutional design).
broadcasting resulted from political compromises. Similarly, in the current debate over the proper protection given to computer software, the battle rages over the appropriate remedy and the role of compulsory licenses. Although the distinctions drawn by the law often are the result of legislative compromise, rather than sound efficiency-minded planning, the economic implications of property rule versus liability rule protection filter into the debate.

1. Overview: Transaction Costs Affect Property Rights Regimes

The choice between property rules and liability rules is often framed in terms of the minimization of transaction costs. A legal system of property rights must not only provide incentives for the creation of property, but must also permit the exchange of property through contract. This concern is in many ways the tension between the right to exclude and the right to access.

A legal system should apply property rules and liability rules to facilitate transactions. The usual prescription is that in low transaction cost environments, property rights should be protected by property rules. Because parties can bargain in low transaction

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146. Guido Calabresi and A. Douglas Melamed were the first authors to use the terminology of property rules and liability rules. Calabresi & Melamed, supra note 22. Their analysis implicitly phrased the choice between the two rules in terms of the costs of transacting. The formal linkage between protection of entitlements and the costs of transacting has become part of the folklore of law and economics analysis. See Ayres & Balkin, supra note 18, at 704-06, nn.2-9.

147. Ayres and Balkin maintain that:

[The best argument for property rules and lower-order liability rules is that they create the right incentives for investment. It is not, as many lawyer-economists have assumed, that they create incentives for more efficient bargains. There is no reason to think that property rules are generally preferable to liability rules in the latter respect.]

Id. at 714.

148. This axiom of law and economics has recently been questioned. See id.; see
cost environments, the law should define property rights and protect them so that the rights can be transferred through purchases. There is, under a property rule, essentially no protection for the right to access, except to the extent that an individual can purchase that right from the holder of the property right.

When transaction costs are high, however, liability rule protection is preferred. Because it is very difficult for parties to bargain in high transaction cost environments, the legal system allows third parties to have access and pay for the access through a court or an agency-administered system. The difficult issue is determining the exact price for the access. The price may be market mimicking, namely, set at a level that would imitate a market negotiated price, or market facilitating, namely, set at a level that would allow the parties to bargain once the terms of the trade are fixed by law.

In effect, transaction costs are like a wall around a medieval fortress. If the wall is low, the fortress should be protected by a property rule that gives the owner the right to stave off the barbarians except for the ones offering to pay to enter. If the wall is high, the fortress should be protected by a liability rule that gives the barbarians the right to climb the wall and pay the guard afterwards. The open question is what determines the height, the thickness, and the penetrability of the wall.

Transaction costs will significantly effect the type of wall protecting the fortress. Transaction costs consist of three types of expenses: (1) information costs arising from disparities in information between the parties and the associated costs of acquiring the relevant information, (2) financing costs arising from differences in wealth that impose costs in acquiring the necessary funds with which to bargain, and (3) administrative costs which, very broadly, would consist of the costs of organizing and administering a legal system, as well as the legal and social costs of transacting to reach an agreed upon bargain. In different contexts, various dimensions of transaction costs will arise in different manners and

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*also Cooter & Ulen, supra note 113, at 93-100 (discussing the conventional wisdom of the rule). But see A. Mitchell Polinsky, *An Introduction to Law and Economics* 15-24 (1989) (criticizing the rule); Ayres & Balkin, supra note 18, at 706 n.11 (same).

149 *Cf. Cooter & Ulen, supra note 113, at 84-89 (classifying transaction costs as search costs, bargaining costs, or enforcement costs).*
amounts. The key to the economic analysis of property rights is to assess the costs and prescribe the desired level and type of protection.

The distinction between property rules and liability rules has been the subject of heated academic debate recently.\textsuperscript{150} The debate has focused on the bargaining game that actors play in resolving disputes and determining the strategies available to the courts seeking efficient bargaining.\textsuperscript{151} In light of this research, property rules and liability rules are “morphed,” resulting in the creation of a new category of remedies.\textsuperscript{152} Ayres and Balkin refer to the new general category of remedies as “auctions,” meaning that bargaining in the shadow of the legal regime can best be understood as a search for the highest value attainable for legal entitlements. A particular property rights regime, with its allocation of rights and system of entitlement protection, creates a system in which parties can bid by exercising their respective options to take and pay or to exclude, until the entitlement is in the hands of the party that is willing to bid the highest for it. The characterization of legal entitlements as auctions brings the Coase Theorem back full circle to its roots in the economic problem of externalities.\textsuperscript{153}

In the neo-classical, Arrow-Debreu model of the economy, externalities arise when there are spillovers from the underlying tech-
technology or preferences in the economy.\textsuperscript{154} Externalities create problems in the market’s ability to allocate resources efficiently. One solution is the Pigovian tax, otherwise referred to as the subsidy solution, which requires detailed centralized information about technologies and preferences in order to set the correct price.\textsuperscript{155} Another possibility is the Coasean decentralized solution, which characterized the externality problem as one of unallocated property rights.\textsuperscript{156} Both solutions build on the insight that externalities pose problems for market economies because the economies lack the markets necessary to allocate the costs and benefits of the externality.\textsuperscript{157} The Pigovian solution resolves the problem through state planning.\textsuperscript{158} A Coasean auction solution, as described by Ayres and Balkin, uses the legal system to supply the missing market through which the legal entitlement is allocated to the highest bidder.\textsuperscript{159}

2. Transaction Costs in Trademark and Copyright

The entitlement structures of trademark and copyright, when examined from a transaction costs perspective, are quite informative. The provisions of the Lanham Act illustrate the analysis. Under the Lanham Act, the trademark owner can seek an injunction and an accounting of profits from the infringer; the infringer cannot take and pay.\textsuperscript{160} Property rule protection for the trademark owner makes sense in light of the goals of the Lanham Act.

As a trademark is designed to denote the quality and source of the product bearing the mark, limiting access is important. Furthermore, access should be limited in accordance with the standards of the trademark owner who has used the mark to convey specific information about quality in the marketplace. By allowing third parties to obtain access to use the mark only through purchase, the law allows the trademark owner control the manner in

\textsuperscript{154} See id.
\textsuperscript{155} See id.
\textsuperscript{156} See id.
\textsuperscript{157} See id.
\textsuperscript{158} See id.
\textsuperscript{159} See id.
which the mark is used. If third parties could take and pay, access would expand at the expense of the information conveyed by use of the mark.

A liability rule would further be undesirable because of valuation problems. The value of the mark will differ based on the geographic region in which the mark is used and the product on which it is used. Because of these complicated valuation issues, a court or agency administered determination of damages will be more costly than a privately negotiated price. Furthermore, because of the recordation system, individuals seeking to purchase use of the mark can determine whom to contact for permission. Finally, trademark owners have the incentive to franchise use of the mark to third parties in order to facilitate the distribution of the product bearing the trademark.

Under the Copyright Act, the nature of the product complicates the balance between exclusion and access. Cable television broadcasts, as noted above, are protected through compulsory licenses. This protection can be justified by the greater need for access and the lesser incentive required to produce works, such as news broadcasts. The value of news depreciates quickly; a system in which the copyright owner can enjoin use of news broadcasts would impede the flow of information and raise transaction costs for the purchase of information.161

Although this rationale justifies a compulsory license system for news, from a consumer perspective, the rationale is weaker for the transmission of works of entertainment. Made-for-television movies are similar to novels, which are protected by a property rule requiring users of the material in a novel to obtain and often purchase the permission from the owner.162 The need for and the gains from access are lower for entertainment works than for news, yet in the context of cable broadcasts, both are protected by the liability rule through a compulsory license system.

161. International News Service v. Associated Press, 248 U.S. 215, 246 (1918) (Holmes, J., dissenting) (stating that there is no general right to forbid others from repeating uncopyrighted information).
There are two economic rationales for this treatment. First, given the low cost of transmitting works through cable television to a wide audience, requiring a court or agency determination of what is news and what is entertainment would raise transaction costs. Therefore, the simplest treatment is to make no distinctions between news and other broadcasts. Second, broadcast television and advertisers actually benefit from the rule requiring compulsory licenses for cable rebroadcasts of broadcast television. Because of the wider audience, advertisers benefit from the rule, as do broadcast networks which can charge higher rates for advertising, part of which would be subsidized by the compulsory license. ¹⁶³

3. Transaction Costs in Secured Credit

Transaction costs also play a role in the protection of debtor and creditor rights in the context of secured credit. The credit relationship between the debtor and the creditor is essentially a contractual one, involving an exchange of promises protected by contract law. The unique problem with a contract for debt is one of monitoring. If the debtor's sole promise is to repay the money given by the creditor sometime in the future, the creditor must expend resources to make sure that the debtor does not become insolvent and unable to fulfill the contractual obligations.

Although all contracts require monitoring, the monitoring costs are potentially quite high in the context of a debt contract because of the risks involved; a creditor will often be financing a new busi-

¹⁶³ The treatment of cable broadcasts contrasts with the proposed compulsory license treatment for computer software. The need for access to computer software serves as the basis for arguments in favor of compulsory license protection for copyright owners of computer software. Because of widespread use and rapid development, access is essential; especially to those who seek to reverse engineer new programs and improve existing programs. Property rule protection would prohibit access. Proponents of property rule protection note the ability of the industry to regulate itself through the use of clearinghouses and private licensing agencies. Without property rule protection, proponents argue that incentives to create software would diminish. Both sides, however, overlook the fact that the software industry developed without copyright protection through the 1970s and 1980s, and that the market provides the basis for much of the incentive to create and innovate software. See generally Menell, supra note 145 (analyzing legal entitlements for software innovations in light of possible market failures and potential legislative obstacles); Merges, supra note 23, at 2662-63 (encouraging use of industry enforcement technology).
ness venture whose success will depend upon the debtor’s efforts and exogenous factors, such as the state of the marketplace. Secured credit ideally is designed to lower monitoring costs by giving the secured creditor an interest in the assets of the debtor. If the debtor defaults, then the secured creditor has the right to recover on the debt contract by obtaining a judicial lien against that portion of the debtor’s assets used as collateral. As a result, the creditor can insure a part of the risk borne by his loan to the debtor. 164

Moreover, the creditor’s interest in the debtor’s assets is protected by a mixed property-liability rule: The right to liquidate the assets and obtain some payment—possibly much less than the value of the debt—from sale of the assets. Full property rule protection would allow the creditor to obtain the full value of the debtor’s obligations, even if the value of the collateral was less than the debt. Under property rule protection for the creditor, the debtor would bear the full risk of default and the creditor would have little or no incentive to monitor the debtor. By according a mixed property-liability rule protection to the creditor, the law passes some of the risk of default to the creditor with the attendant requirements of monitoring. 165 The net result is a system that

164. Secured debt can be issued with a lower risk premium than unsecured debt, thereby reflecting the lower risk involved because of the creditor’s security interest in the debtor’s assets. See Paul M. Shupack, Solving the Puzzle of Secured Transactions, 41 RUTGERS L. REV. 1067, 1085-87, 1125-29 (1989) (showing that risk premiums are lower for secured creditors). See Thomas H. Jackson & Anthony T. Kronman, Secured Financing and Priorities Among Creditors, 88 YALE L.J. 1143 (1979), for an analysis of the monitoring role played by secured credit. See Saul Levmore, Monitors and Freeriders in Commercial and Corporate Settings, 92 YALE L.J. 49, 49-50 (1982) (arguing that secured credit with priority can lower monitoring costs and prevent asset substitution); see also GAME THEORY, supra note 125, at 195-202 (analyzing the problems associated with monitoring costs); Randal C. Picker, Security Interests, Misbehavior, and Common Pools, 59 U. CHI. L. REV. 645 (1992) (describing the effect of secured credit on monitoring costs); James J. White, Efficiency Justifications for Personal Property Security, 37 VAND. L. REV. 473, 491-94 (1984) (arguing that secured credit reduces risk aversion by creditors and that unsecured creditors benefit from monitoring performed by secured creditors and therefore have a lesser need for a risk premium).

165. If the secured creditor were fully insured, there would be no incentive to monitor the debtor—thus undercutting the arguments that secured credit benefits both the secured and unsecured creditors of the debtor. See supra note 164. By offering less than full property protection, the secured creditor is forced to monitor the debtor to avoid asset substitution, for example, or to ensure that the collateral is not being wasted. See Ken-
avoids the moral hazard created by full insurance against default, and accords the creditor and the debtor the flexibility to transact over the course of the debt.

The divided ownership problem in the secured credit context poses difficulties for other creditors of the debtor. Although part of the problem, resulting from the separation of possession and ownership noted in *Benedict v. Ratner*, is alleviated through a recording system, secured credit arrangements may increase the overall cost of using debt to finance ventures. Secured credit, however, reduces the cost of obtaining debt from secured creditors because such creditors will agree to a lower rate of interest in exchange for a security interest. The debtor can use the same collateral to secure debt from other creditors, who will raise the interest on the debt to reflect the fact that another secured creditor has an interest in the collateral. Secured creditors rights in regard to each other are protected through property rules.

Nevertheless, the use of security may raise the costs of unsecured credit. Unsecured creditors’ rights are protected through

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166. “Moral hazard” is defined as:

In fire insurance, the risk or danger of the destruction of the insured property by fire, as measured by the character and interest of the insured owner, his habits as a prudent and careful man or the reverse, his known integrity or his bad reputation, and the amount of loss he would suffer by the destruction of the property or the gain he would make by suffering it to burn and collecting the insurance.


167. See Ayres & Balkin, supra note 18 (concluding that choice between property rules and liability rules is more about creating proper incentives for investment than about facilitating bargaining).

168. See Game Theory, supra note 125 (demonstrating analytically necessity of priority to ensure monitoring behavior by secured creditors); Picker, supra note 164.

169. See Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEG. STUD. 1, 7-9 (1981) (questioning efficiency gains of secured credit on grounds that security interests are a transfer from unsecured to secured creditors); see also Alan Schwartz, *The Continuing Puzzle of Secured Debt*, 37 VAND. L. REV. 1051, 1068 (1984) (suggesting that “answers to the secured debt puzzle are less likely to be found in simple notions that ‘security interests reduce risk’ than in careful analyses of the differing preferences for security among debtors and creditors”). Professor Schwartz’s critique is based largely on the Modigliani-Miller Theorem (“Theorem”).
contract and a tangled mix of property and liability rules. Although unsecured creditors are exposed to the risk of the debtor entering bankruptcy, in which the obligations to unsecured creditors would be liquidated at much less than the value of the claims, an unsecured creditor has the right, prior to bankruptcy, to obtain a judicial lien against the debtor’s assets and become a lien creditor. A lien creditor has in many ways the status of a secured creditor, especially in obtaining the priority of his claims against the debtor over subsequent secured creditors with unperfected interests. Although lien creditors lack security for their loans, the monitoring costs of unsecured debt may be lower because of the creditor’s ability to transform his interest from one that is unprotected, vis-à-vis other creditors, to one that is protected through a property rule.

Property rule protection for the rights of creditors, toward each other, almost certainly lowers the transaction costs of debt financing. If creditors could “take and pay,” that is, recover the debt from the debtor’s assets and compensate other creditors for the loss, the transaction costs of debt financing would increase. Administrative costs would rise as the court determined the costs associated with each creditor’s interests by the “taking” creditor. Furthermore, information costs would increase because creditors would face the uncertainty of not knowing which creditor will act first to take from the debtor’s assets. Under a property rule regime, creditors can purchase priority rights from other creditors which states that in a world of perfect competition, a company’s debt/equity ratio does not affect the company’s value. The Theorem applies not only to the choice between debt and equity but also to the choice among different types of debt. See Franco Modigliani & Merton Miller, The Cost of Capital, Corporation Finance, and the Theory of Investment, 48 AM. ECON. REV. 261 (1958). See Barry E. Adler, An Equity-Agency Solution to the Bankruptcy-Priority Puzzle, 22 J. LEGAL STUD. 73, 77-89 (1993), for one response to Professor Schwartz’s arguments that resolves the bankruptcy priority puzzle.

170. There is a parallel between secured credit and unsecured credit that has not been formally explored. See Theodore Eisenberg, The Undersecured Creditor, in Reorganization and the Nature of Security, 38 VAND. L. REV. 931, 960-63 (stating that “the difference between secured and unsecured forms of debt is more one of degree than of kind”); see also George Triantis, Secured Debt Under Conditions of Imperfect Information, 21 J. LEGAL STUD. 225, 255-58 (analyzing how secured debt can affect both agency costs and signaling costs).

171. See Adler, supra note 169; Picker, supra note 128.
and restructure the priority determined by state law. Because creditors are usually sophisticated players, the bargaining costs are lower in resolving priority disputes through property rules, rather than liability rules.\footnote{172}

B. Analysis of Trademarks and Copyrights as Collateral

The rationales behind the choice between a property rule and a liability rule, when copyrights and trademarks are used as collateral, are integral to understanding the resulting problems. In terms of obtaining priority among creditors in settling claims against the debtor, the issue is one of certainty and proper notice under the current system of priority. When a secured creditor has an interest in a copyright or in a trademark, it is uncertain where the creditor must file his interest in order to perfect and obtain priority. The current law can be divided into three categories: (1) a dual system for copyrights and trademarks, (2) a “belt and suspenders” approach, and (3) a veil of ignorance approach. Each of these systems undermines the balance between property and liability rules in the current system of secured credit and intellectual property.

1. Current Law and Problems

The dual system was created by \textit{In re Peregrine Entertainment Ltd.}\footnote{173} and \textit{In re Joseph v. 1200 Valencia, Inc.,}\footnote{174} two California bankruptcy decisions which held that security interests in a copyright can be perfected only by a federal filing with the Copyright Office and security interests in a trademark can be perfected only by an appropriate state filing. The reasoning behind these two opinions rests on section 205 of the Copyright Act and section 10 of the Lanham Act. Both provisions deal with priority disputes among subsequent assignees of the copyright or trademark. In addition, both sections impose recording obligations on the assignee

\footnotesize{\begin{itemize}
\item \footnote{172} This is consistent with the view that “[b]ankruptcy law creates a bargaining environment in which Creditor and Manager negotiate with each other.” \textit{Game Theory}, supra note 125, at 233; see also Douglas G. Baird & Randal C. Picker, \textit{A Simple Noncooperative Bargaining Model of Corporate Reorganizations}, 20 \textit{J. Legal Stud.} 311 (1991).
\item \footnote{173} 116 B.R. 194 (1990).
\item \footnote{174} 137 B.R. 778 (1992).}
\end{itemize}}
to record the assignment at the federal level.

The provisions differ in one fundamental way; the Lanham Act applies solely to assignments, namely, contractual transfers of title, while the Copyright Act applies to assignments and transfers, the latter constituting transfers of rights that do not involve transfers of title. The Bankruptcy Court in California has read “transfer” under the Copyright Act to include transfers of security interests. As a result, security interests are governed by the Copyright Act, but not the Lanham Act. Furthermore, because of the doctrine of implied preemption, the need to record the transfer of a security interest under the Copyright Act preempts state law requirements.

This interpretation of the Lanham and Copyright Acts not only creates a dual system for copyrights and trademarks, but also introduces several lacunae in the law. First, priority disputes among assignees under the Lanham Act are resolved through a first to file rule. This rule, however, does not address disputes between secured creditors and assignees. As previously discussed, this gap

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175. See Peregrine, 116 B.R. at 204 n.14.
176. See generally Lydia A. Nayo, Revisiting Worth: The Copyright as Community Property Problem, 30 U.S.F. L. REV. 153, 162 (1992) (describing the application of the doctrine of implied preemption). According to one commentator:

   Under the doctrine of implied preemption, where a federal statute does not expressly prohibit application of state law to the federal benefit generated by the statute, preemption is implied to the extent that application of the state scheme does “major damage” to a “clear and substantial” interest in the federal legislation.

   Id. (citing Hisquierdo v. Hisquierdo, 439 U.S. 572 (1979); City of Burbank v. Lockheed Air Terminal, Inc., 411 U.S. 624 (1973)).
177. The court in Peregrine noted that although:

   The Copyright Act [under section 301] does expressly preempt state law in respect to the exclusive rights possessed by holders of copyright under federal law.

   Section 301 is inapplicable because here we are concerned not with the creation of the exclusive rights under section 106, but rather their transfer through the creation of a security interest.

116 B.R. at 199 n.6 (citations omitted). The court, however, did base its decision on the policy goals underlying the Copyright Act of “predictability and certainty of copyright ownership” and the need to “avoid the practical difficulties of determining and enforcing an author’s rights under the differing laws and in the separate courts of the various States.” Id. at 199 (citing Committee for Creative Non-Violence v. Reid, 490 U.S. 730 (1989)).
178. See Weinberg & Woodward, supra note 109, at 124-25 (recommending the
is a problem under bankruptcy law. Second, although the Copyright Act adopts a first to file rule that would apply to licensees and transferees, the Copyright Act also has special timing rules that give transferees up to three months to file against subsequent transferees or licensees. From the perspective of a secured creditor, the timing and federal filing rules adds uncertainty to the process of entering into secured credit arrangements. Because federal filing occurs on the basis of title and registration number, whereas state filings are based on the debtor’s legal name, the secured creditor will find it more difficult to determine the priority of claims under federal law than under state law.

The dual system of filing for copyrights and trademarks increases the cost for secured credit. The problem is exacerbated by the fact that the same item often can be protected by both copyright and trademark laws. In many instances, copyright and trademark may blend into each other and the dual system may effectively turn into a “belt and suspenders” approach, whereby the secured creditor makes both a state and a federal filing, increasing the transaction costs of secured credit.

Even if the legal cost of duplicative filings is low, a dual filing system may not provide adequate protection for several reasons. First, there are the potential preemption issues. If a court finds that a copyright filing preempts the state filing, leading to a different result as to priority, the protection of the law is lost. Furthermore, the timing rules for filing differ between state and federal laws, adding confusion with regard to the determination of priority.

The lack of awareness of these issues also creates confusion over how to perfect security interests in copyrights and trademarks. Many practitioners do not even know of the possible need to consider federal law. As a result, copyrights and trademarks are

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180. See Haemmerli, supra note 11, at 1723-29; see also Weinberg & Woodward, supra note 109, at 79-92 (discussing the difficulty in determining the priority of claims).
181. This confusion is evidenced by the court’s decision in Roman Cleanser. See discussion supra note 100 (quoting Roman Cleanser court’s opinion regarding confusion in filing).
treated like general intangibles, and interests are perfected accordingly. The implications are that many security interests in copyrights and trademarks are never perfected, exposing secured creditors to the risk that their interests may be trumped by other creditors or converted to unsecured debt in bankruptcy.

2. Critique of the Federal Filing System as a Potential Remedy

One remedy to the confusion over where to file interests in copyrights and trademarks is a federal filing system, embracing all intellectual property interests. This proposal needlessly increases the costs of secured credit without addressing the issues raised by intellectual property. A system of federal filing creates conflicts between the Copyright Office and the P.T.O. over the appropriate place to file security interests and increases the administrative burden. A federal system also increases the search costs for creditors attempting to establish priority.

Proponents of a federal system analogize copyrights and trademarks to the treatment of government licenses, such as Federal Aviation Administration certificates or Federal Communications Commission licenses, under article 9. Unlike its treatment

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183. See id. § 9-302(1) (providing rules for perfecting security interests in general intangibles); see also id. § 9-401 (setting out rules for location of filing).
184. Some reform proposals circumvent this problem by creating a separate federal agency for governing the filing of security interests in trademarks and copyrights. See Weinberg & Woodward, supra note 109, at 79-84.
185. Currently, the problems are exacerbated because registrations of security interests under state law are under the debtor’s name, while registrations of trademarks and copyrights are under the name of the protected work or mark.
186. See G.S. Rasmussen & Assoc. v. Kalitta Flying Serv., 958 F.2d 896, 905 (9th Cir. 1992) (finding that allowing individual state recording requirements to control would have impermissibly conflicted with goal of uniformity, and holding that Supplemental Type Certificates issued by Federal Aviation Administration are property) (citing In re Peregrine, 116 B.R. 194 (1990)). Article 9 “does not apply to a security interest subject to any statute of the United States to the extent that such statute governs the rights of parties to and third parties affected by transactions in particular types of property.” U.C.C. § 9-104(a).
of federal licenses, article 9 does not mandate federal filing for copyrights and trademarks. A federal filing requirement for copyrights and trademarks would be permitted under article 9, but the rationale would differ from the mandatory requirement for licenses, which are wholly the creation of the federal government.

Copyrights and trademarks are federal property rights of a different sort because they are rights that also have a large state or local component. A trademark, for example, must first be developed in local markets and used in interstate commerce before federal protection attaches. A federal property right under copyright is created as soon as a work is placed in a tangible medium of expression, but the same work may be protected by state law, including state trade secret law. Furthermore, rights under both trademark and copyright can be transferred through contract. Therefore, unlike government licenses, trademarks and copyrights also embody a slew of state rights.

Federal involvement in the creation of trademarks and copyrights is not a sufficient justification for creating a federal recordation system. The purpose of recording security interests is for a secured creditor to establish property rights against other creditors. Unless there is a compelling federal interest for federal recording, as there is for federal licenses, no special need calls for a separate system for recording security interests in copyrights and trademarks.

Arguably, one compelling reason for a federal system is the language of the Copyright Act that requires the filing of transfers

187. Article 9 provides that state filings are not effective if there is an adequate system of filing, either state or federal, outside article 9. Id. § 9-302(3). If such a system exists, then perfection can occur only through a filing under the alternative system. See id. § 9-302(4). Deciding whether a federal scheme for registering copyrights and trademarks is adequate is crucial for determining whether article 9 mandates a federal filing. The Peregrine court maintained that a federal filing scheme is adequate. See supra note 97 (citing Peregrine). The Peregrine court, however, also stated that the federal filing system did not preempt the state system. Contrast the court’s decision in Joseph, where it held that a federal system for trademark filing was not adequate because section 1060 of the Lanham Act applied only to assignments. In re Joseph, 137 B.R. 778, 778 (1992). The Joseph court seemingly ignored or underplayed the uniformity goals of trademark law. Because there is no preemption of state law regarding security interests by either the Copyright Act or the Lanham Act, it is unclear whether a federal filing is required. See id.
of copyrights. This reference to transfers, however, is not designed to preempt state filing systems. Therefore, the filing requirement under the Copyright Act should not be read as a substitute for, or an additional requirement to, the state filing which is necessary for a secured creditor to preserve his right against other creditors. The filing requirement under the Copyright Act, however, is needed for the secured creditor to preserve his rights against subsequent assignees.

In contrast, the Lanham Act is silent on how a secured creditor can preserve his rights. Although the Lanham Act does not require a federal filing of security interests by secured creditors, it does create a system for allocating rights among assignees.\textsuperscript{188} The Lanham Act and state law are silent on how to resolve conflicts between secured creditors and assignees. Because of such gaps, which become even wider in bankruptcy, the creation of a federal system of filing is not by itself an adequate means to resolve the problems of secured credit in intellectual property.

III. HOW AND WHY BANKRUPTCY LAW TRANSFORMS LIABILITY RULES INTO PROPERTY RULES

Bankruptcy is a procedural device through which a debtor can restructure his contractual rights against the rest of the world. The restructuring can occur either through a reorganization plan or through liquidation and discharge.\textsuperscript{189} Part of the bankruptcy procedure entails establishing the scope and the value of the debtor’s estate, which will serve as the basis for determining the restructuring or liquidation. In providing rules for assembling the debtor’s estate, the Bankruptcy Code helps to establish the debtor’s property rights in various assets that comprise the estate, including con-
The reorganization or liquidation phase of bankruptcy allows the debtor to settle various claims against third parties. Because of this two part nature of bankruptcy procedure, the Bankruptcy Code is comprised in of both property and liability rules.

190. Under 11 U.S.C. § 541(a)(1), the trustee is given “all legal or equitable interests of the debtor in property as of the commencement of the case.” Id. In addition, there are many issues surrounding the assembly of the bankruptcy estate. See GAME THEORY, supra note 125, at 94-100; see also LOGIC & LIMITS, supra note 119, at 89-104 (stating that determining which assets are included within an estate rests on asking whether the estate is “more valuable with the item under consideration than without it”).

191. See Thomas H. Jackson, Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors’ Bargain, 91 YALE L.J. 857, 893-95 (1981) (exploring similarities between liquidation and reorganization). The bankruptcy process, whether in the form of liquidation or reorganization, aims to settle claims while allowing the debtor to continue as a going concern. This goal underlays the broader goal of providing the debtor with a fresh start. The fresh start rationale is coincidental to the monitoring goals of bankruptcy and of ensuring creditors of the financial health of the debtor. See GAME THEORY, supra note 125, at 15 (“[T]he bankruptcy process can offer scrutiny of the debtor’s overall health that no individual creditor can match.”).


[M]odified property rules have been imposed on people who are either insolvent or about to die. In both cases, these rules solve problems that arise because someone with an interest in the property has no formal legal claim until some event, i.e. bankruptcy or death occurs . . . . The modified property rule is a second-best way of recognizing the property interests of creditors, heirs, and tax collectors in situations where the nominal owner may choose to overlook their claims.

Id.; see also Madeline Morris, The Structure of Entitlements, 78 CORNELL L. REV. 822, 847 (1993) (generalizing Calabresi-Melamed typology to cover sixteen types of property entitlements). The distinctive roles of property and liability rules can also be seen in the substantive differences between liquidation and reorganization. See Jackson, supra note 191, at 896. “Normally in a liquidation under Chapter 7, the assets are sold off and the ‘debtor’ is effectively removed from the picture. Third parties are almost certainly involved as ‘owners’ if not as managers. The essence of a reorganization, however, is that third parties are not involved.” Id. Bankruptcy default rules limit the ability to contract out and are, in effect, property-like in application. “The benefits of standardized distributional rules suggest that the traditional contractual freedom to opt out of the creditors bargain might sensibly be restricted in bankruptcy. Bankruptcy law is neither a pure contractarian nor a strictly regulatory legal regime.” Thomas H. Jackson & Robert E. Scott, On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors’ Bargain, 75 VA. L. REV. 155, 203 (1989).
A. The Bankruptcy Code Transforms Liability Rules Into Property Rules

In addition to containing both property and liability rules, the Bankruptcy Code transforms liability rules into property rules. This section provides an overview of the transformation, followed by more detailed investigations of sections 365(a) and 365(n).

1. Overview of the Transformation

Some provisions of the Bankruptcy Code meld both property rules and liability rules. Section 365, which concerns the assumption or rejection of executory contracts, is one example of this mixed regime. Under section 365, in managing the debtor’s estate for the benefit of the creditors, the trustee can elect to either assume or reject ongoing contractual obligations of the debtor which are “executory” in nature. There is a vast amount of literature devoted to the meaning of “executoriness” and many courts apply a test of “executoriness” before applying section 365. This Article adopts the Countryman definition that, a contract is executory if performance obligations are outstanding on both sides of the contract.

The mixed property rule-liability rule nature of section 365 is exemplified by understanding the principal purposes behind the provision. The trustee’s authority to either assume or reject an executory contract is consistent with her authority to assemble the debtor’s estate. By asserting the debtor’s rights through assump-


194. The classic definition of “executory contract” is “a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.” Vern Countryman, Executory Contracts in Bankruptcy: Part I, 57 MINN. L. REV. 439, 460 (1973). This definition of executory contracts has been adopted by almost all bankruptcy courts as a prerequisite for the application of section 365. See Jordan & Warren, supra note 121, at 316. Nevertheless, some commentators have criticized the application of this definition as a prerequisite for section 365. See Westbrook, supra note 125, at 243; see also Michael Andrew, Executory Contracts in Bankruptcy: Understanding ‘Rejection’, 59 U. COLO. L. REV. 845 (1988); Michael Andrew, Executory Contracts Revisited: A Reply to Professor Westbrook, 62 U. COLO. L. REV. 1 (1991).

195. See Countryman, supra note 194, at 460.
tion of contracts that are profitable to the estate and rejection of contracts that are not profitable, the trustee furthers the goal of maximizing the value of the debtor’s estate. In rejecting the unprofitable contractual obligations, however, the trustee gives third parties claims to be liquidated in bankruptcy. As a result, section 365 creates a mixed property rule-liability rule regime, within which the trustee can seek performance of obligations that increase the value of the estate and liquidate claims that do not.196

Application of section 365 is particularly confusing, especially in the intellectual property context, because its provisions transform what would be liability rules in the non-bankruptcy setting into property rules under bankruptcy. If the choice between property and liability rules is based solely on transaction costs, then the transformation within bankruptcy may make sense. Transaction costs are lower within bankruptcy because negotiations among the trustee and creditors are orchestrated by the court and choreographed by detailed rules. The problem is that bankruptcy law often affects bargaining that occurs outside of bankruptcy.197 Furthermore, it is likely that bankruptcy law transforms the nature and source of transaction costs, instead of eliminating them. Each of these points is illustrated by the bankruptcy treatment of intellectual property under section 365.

Indicative of how bankruptcy law alters non-bankruptcy contractual and property relations is the definition of intellectual property under the Bankruptcy Code.198 Although copyrights are intellectual property under the Bankruptcy Code, trademarks are not.199 The exclusion of trademarks is as much about legislative compromise as it is about respecting the goals of trademark law.200 Be-

196. See GAME THEORY, supra note 125, at 116; Westbrook, supra note 125.
197. See GAME THEORY, supra note 125, at 232-37; see also Jackson, supra note 191, at 907 (“[W]e would be better able to formulate and apply principled bankruptcy rules if we would give systematic and critical attention to the impact of those rules on non-bankruptcy entitlements.”).
199. Id.
200. One commentator stated that:
The exclusion of trademarks from the definition of intellectual property stemmed from “Congress’s” concern . . . centered around new and unproven start-up companies in the computer software and biotechnology industries,
cause of the exclusion, separate rules govern trademarks and copyrights under section 365. Consequently, section 365(n) deals specifically with licenses of intellectual property when the licensor is bankrupt. As a result, the rules change depending upon whether the bankrupt party is the licensor or the licensee of intellectual property. Quite simply, trademarks and licensee bankruptcy are governed by what this Article refers to as the “365(a) regime.” Bankruptcy by licensors of non-trademark intellectual property is governed by what the “365(n) regime.”

2. The 365(a) Regime

Under the 365(a) regime, the trustee can either assume or reject the debtor’s contractual obligations. The choice of assumption by the trustee corresponds to property rule protection for the debtor’s contractual rights; the debtor can seek specific performance on the contract. If the third party breaches, the debtor will have a claim for contractual breach, which will be an asset of the debtor’s estate. If the trustee chooses to reject the contract instead, the third party will have a claim for breach of contract against the debtor’s estate, which will be treated as an unsecured claim. Assumption and rejection together correspond to property-like protection for the debtor’s rights because the third party’s claim for breach, in the event of rejection, will be for substantially less than the full amount of contractual damages.201

which were heavily dependent on licensing . . . . [T]he primary purpose of the amendment was to protect technology licensing; . . . the legislative history indicates that Congress specifically did not intend, by amending § 365, to “bring every retail franchise involving a trademark within the purview of the legislation, thus extending the reach of the bill far beyond what appears necessary.”


201. See Westbrook, supra note 125 (pointing out that upon rejection, the debtor will have to pay damages on the executory contract in “bankruptcy dollars,” i.e., at a reduced portion of the amount of damages). The difference between liability rules and property rules is one of degree rather than of kind:

[T]he only difference between liability and property rules is the price of exercising the option—the damages to be paid for the non-consensual taking. Property rules set the exercise price so high that no one is likely to exercise the option to take nonconsensually, while the lower exercise prices of liability rules presuppose that some people will take nonconsensually.
In many instances, the 365(a) regime alters the corresponding non-bankruptcy regime. For example, if a trademark owner in the mark “NoBorders” licenses the right to use the mark as part of a franchise and enters into bankruptcy, under section 365(a), the trademark owner has the right to reject the franchise agreement and enjoin the franchisee from use of the mark.\textsuperscript{202} The property rule protection, under bankruptcy, corresponds to the property rule protection for the trademark owner’s rights in the mark under the Lanham Act. If the franchisee files for bankruptcy, however, the franchisee can assume the contract and continue using the mark, essentially enjoining the franchisor from denying access to the mark. Under non-bankruptcy law, the franchisee’s rights are protected solely by contract law; if the franchisor denied access or breached the franchise agreement, the franchisee would have a claim for damages against the franchisor. In bankruptcy, the franchisee can obtain the equivalent of specific performance.\textsuperscript{203}

The rights of franchisees and franchisors under section 365 are also affected by security interests in the mark. If a bank, for example, has a security interest in the mark, the bank can seek adequate protection for its rights in the mark in the event of rejection by the trustee. If the franchisor files for bankruptcy and rejects the franchise, a bank with a security interest in the mark can petition the court for adequate protection of its rights in the mark.\textsuperscript{204}

\textsuperscript{202} 11 U.S.C. § 365(a). “[T]he trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor.” Id.; see Game Theory, supra note 125, at 122-23 (analyzing an example based on the franchise of a trademark).

\textsuperscript{203} This conclusion stems from the implications of the assumption powers under section 365. See Game Theory, supra note 125, at 141; see also Anthony Kronman, Specific Performance, 45 U. Chi. L. Rev. 351 (1978) (discussing specific performance in the contracts context); Alan Schwartz, The Case for Specific Performance, 89 Yale L.J. 271 (1979).

\textsuperscript{204} See 11 U.S.C. § 365.
Specifically, if the value of the mark would be greater under the continuation of the franchise relationship, the bank as secured creditor can protect its interest in the mark by either requiring the franchisor to continue the relationship or to obtain financial protection, such as through cash or an equivalent secured claim in another asset. In this way, the secured creditor’s rights are still protected by a property rule when the franchisor enters bankruptcy. If the franchisor rejects these options, however, the secured creditor will still have a claim in the mark, but the franchisee will only have an unsecured claim in bankruptcy. Section 205(e) of the Copyright Act provides that among disputes between licensees and secured creditors, the first in time rule prevails. Under the application of section 365(a), the priority could be reversed. Essentially the secured creditor’s rights against assignees of the mark are protected by a property rule.

Reverse the situation and make the franchisee the debtor and the bank a secured creditor of the franchisee. If the franchisee rejects, the secured creditor can still obtain adequate protection, which, if granted, would allow the creditor’s rights to trump the franchisee’s right to reject. Once again, the secured creditor’s rights are protected by a property rule and, contrary to the provisions of section 205(e) of the Copyright Act, the secured creditor’s rights would obtain priority over the rights of the franchisee.

3. The 365(n) Regime

The 365(n) regime also transforms the rights of parties operating in the non-bankruptcy regime. Section 365(n), known popularly as the “Intellectual Property Protection Act,” applies only to situations in which the licensor of intellectual property is the bankrupt party.206 For the purposes of section 365(n), “trademarks” do not fall into the definition of “intellectual property.”

Under section 365(n), if the licensor chooses to reject the license, the licensee has the right to continue under the license or to seek a claim for breach of contract. Thus, in the event of a rejection, the licensee can elect either damages or specific performance

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as a remedy. The licensee’s rights are protected by a property rule in the event of a rejection. In contrast, under non-bankruptcy law, the licensee would more than likely be relegated to liability rule protection for his rights under the license.

B. The Rationale Behind the Bankruptcy Code

The bankruptcy treatment of property rights in intellectual property licenses raises two questions: (1) whether bankruptcy law imposes a different set of property rights than applicable non-bankruptcy law, and (2) whether the particular transformation made by bankruptcy makes sense. Toward answering these questions, this section addresses the recurring concerns of transaction costs within bankruptcy, executory contracts, and the rationales behind the 365(n) regime.

1. Transaction Costs

Arguably, transaction costs within bankruptcy are lower than outside of bankruptcy. Bankruptcy law provides procedural rules for the liquidation or reorganization of the debtor’s estate, thereby reducing the administrative and search costs that would arise if the debtor had to bargain with all the creditors. Furthermore, information problems are lower in bankruptcy; valuation of assets is determined by the trustee—or at least settled through litigation among the parties—if there is a dispute as to the value of a particular asset. As a result, bankruptcy is largely an issue of

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207. This conclusion is reached inferentially from the definition of transaction costs. See supra note 149 (defining transaction costs). “In general, transaction costs include the costs of identifying the parties with whom one has to bargain, the costs of getting together with them, the costs of the bargaining process itself, and the costs of enforcing any bargain reached.” Polinsky, supra note 148, at 12. As compared to the costs outside of bankruptcy, each of these elements are lower within the bankruptcy context. Bankruptcy provides a forum for the debtor and creditors to liquidate or restructure; as a result, the first two costs, of identifying and getting together, are necessarily lower. Bankruptcy provides detailed rules for how to bargain and enforce the non-bankruptcy bargain as administered by the trustee, thereby reducing the costs of the bargaining process. Finally, the costs of enforcing the bankruptcy decree, whether in liquidation or reorganization, may be sizable, but is definitely lower than the free-for-all enforcement under state law. See Jackson, supra note 191, at 7 (maintaining that the primary purpose of bankruptcy law is to reduce the collective action problem).

208. In liquidation proceedings, “the valuation procedures are far from intractable.
how the pie is to be divided or restructured based on given rules. Because transaction costs are lower within bankruptcy, the preference given to property rules facilitates bargaining within bankruptcy.

Property rules within bankruptcy would also provide lower transaction costs than outside of bankruptcy. If bankruptcy rules allow for predictability, then contracting parties can, at least theoretically, value the contractual relationship upon the contingency that one of the parties enters bankruptcy.\textsuperscript{209} Bankruptcy law provides clear, immutable default rules for the contracting parties who may underestimate the probability of bankruptcy, and hence not prepare through express contractual terms for its occurrence. Bankruptcy certainly fulfills this purpose by respecting the state rules of priority, at least among secured and unsecured creditors. The trustee, with his strong arm powers under section 544,\textsuperscript{210} has the power to subordinate secured creditors who are not perfected at the time the bankruptcy petition is filed, just as any judicial creditor who obtained a judgment against the debtor’s estate would.

\textbf{2. Executory Contracts}

The treatment of executory contracts, however, does not correspond to the view of bankruptcy as providing clear, immutable rules that would allow contracting parties to value their positions in the contingency of bankruptcy. Regardless of the nature of the long term relationship between the debtor and the third party outside bankruptcy, once the debtor files for bankruptcy, the debtor’s rights under the contract are protected by a property rule: He either receives specific performance or chooses to breach at a reduced

\footnotesize{The claims are measured, their relative priority is determined, and the proceeds, which because they are cash or marketable securities are easily valued, are distributed to the claimholders in the order of their relative nonbankruptcy entitlements.” LOGIC & LIMITS, supra note 118, at 211-12. In reorganization, the valuation problems are more difficult because the trustee and the creditors must value new claims against the debtor. “Determining these values without using a market pricing mechanism is one of the hallmarks of a bankruptcy reorganization proceeding. It is principally these valuation issues that lie at the core of the reorganization chapter’s provisions.” Id. at 212.


\textsuperscript{210} 11 U.S.C. § 544(a).}
level of damages. The rules of bankruptcy are even stronger because "ipso facto" clauses, namely, clauses which state that the simple act of filing a bankruptcy petition is a material breach of contract, are held to be invalid. The rules of bankruptcy are even stronger because "ipso facto" clauses, namely, clauses which state that the simple act of filing a bankruptcy petition is a material breach of contract, are held to be invalid. Furthermore, liquidated damages clauses are not enforceable if the debtor chooses to reject the contract; the third party can recover only actual contract damages. As a result, third parties cannot structure the contract in a way to protect their rights within bankruptcy. For third parties engaging in a long term contract with the debtor, bankruptcy law places discretion to continue under the contract in the hands of the debtor.

From the perspective of the debtor, the discretion accorded by the bankruptcy treatment of executory contracts is justifiable. Section 365 concerns the assembly of the debtor’s estate; it is not an avoidance power, such as sections 544, 547, and 548. The purpose of section 365 is to allow the trustee to manage the debtor’s estate without the burden of contractual obligations that diminish the value of the estate due to their inherent unprofitability. In this way, debtors are able to shift market risks off to the other contracting party, while allowing the trustee to maximize the value of the estate for the benefit of all the creditors. Nevertheless, the manner in which the trustee can use section 365 as an instrument of his avoidance power is troublesome. Just as fraudulent conveyance law allows the trustee to rescind pre-bankruptcy contractual...
arrangements, the trustee can rescind pre-bankruptcy executory contracts that are unprofitable under section 365. The rescissionary power is limited only by the need to pay damages for breach, albeit at greatly reduced terms.

The treatment of executory contracts is especially troubling in the context of intellectual property. Under the current regime, the trustee in bankruptcy can assume or reject a trademark license. If the debtor is the licensor, the protection accorded under section 365 is similar to that accorded under trademark law, that is, property rule protection for the underlying rights in the trademark. If the debtor is the licensee, however, the rights are starkly different under bankruptcy than under applicable non-bankruptcy law. The licensor of the trademark assumes the risk that the licensee will enter bankruptcy and elect to assume a license that may have become unprofitable to the licensor. Although the trademark owner still has the obligation to ensure that the goodwill underlying the trademark does not depreciate, the owner no longer has the right, in the event of the licensee’s bankruptcy, to rescind the license once the trustee has assumed it.

Rights under the license are symmetric under bankruptcy law with respect to termination rights. In fact, they are more symmetric than in the non-bankruptcy contract, where the licensor can sue for infringement and the licensee can sue only for damages in case of breach by the licensor. But the symmetry of the situation cannot explain the transformation of the licensee’s rights in bankruptcy from a liability rule to a property rule.

The puzzle can be resolved by understanding the nature of property rights at issue within the bankruptcy and the non-bankruptcy regimes. Under the non-bankruptcy regime, the licensee’s rights are protected with respect to the licensor. In bankruptcy, however, the licensee’s rights are protected not against the licensor alone, but against all of the licensee’s creditors. The question from the trustee’s perspective is whether the licensee should continue performance under the license in order to maxi-

216. This is implicit in the notion that bankruptcy should be designed to protect the creditors’ bargain. See Jackson, supra note 191; Jackson & Scott, supra note 192.
mize the estate for the benefit of all creditors. As a result, the decision to assume or reject by the trustee, when the licensee is the debtor, is a transfer from the licensor to all of the creditors. In contrast, the rights of the licensor under the trademark license are against the rest of the world, not just against the specific licensee. Consequently, under section 365, bankruptcy law respects the property rights system for trademark owners under non-bankruptcy law and expands rights for licensees, because bankruptcy’s goal is to restructure or liquidate the debtor’s obligations with regard to all creditors.

3. Analyzing Rationales Behind the 365(n) Regime

The 365(n) regime demonstrates that the scheme for non-trademark intellectual property is decidedly different. Nevertheless, it is fair to query whether the distinction between trademark and other types of intellectual property makes sense. At one level, the distinction is logical because the property rights system under trademark is distinct from the system for the other types of intellectual property.

It is important to contrast the treatment of trademark with that of copyright. Under copyright law, the owner of the intellectual property can protect his rights against the rest of the world through property rules, with some major exceptions for compulsory licenses and other exceptions under the fair use doctrine. If the purpose of bankruptcy law is to provide certainty for contracting parties in their valuation of the bankruptcy contingency, then bankruptcy law should respect non-bankruptcy law as much as possible. As a result, a different scheme for copyright would be warranted.

Nevertheless, it is worthwhile to consider whether the scheme imposed by section 365(n) is appropriate. If the licensor is the debtor, then under section 365(n), the licensee has the option to choose remedies upon either assumption or rejection by the trustee. In effect, the licensee’s rights are protected by a property rule within bankruptcy, when it would have been protected by a liability rule outside of bankruptcy. Furthermore, under non-bankruptcy law, the licensor’s rights under the license are protected by a mixed property-liability rule against the licensee. Within bank-
ruptcy, the licensor’s rights are to be ascertained with respect to all creditors, not simply the licensee. Unlike trademark, in which the licensor has clear rights in the use of the mark, in the context of copyright, the scope of the licensor’s rights under the license are unclear.

The anomaly in bankruptcy’s treatment of copyright is underscored by the asymmetric treatment of licensor and licensee bankruptcies. If the licensee is the debtor, then the trustee can assume or reject the license for the copyrighted work just as the trustee could in the case of a trademark license. The licensee’s rights in the license are protected by a property rule within bankruptcy. As with trademark, bankruptcy law transfers value from the licensor to all of the licensee’s creditors. The policy reason for this transfer is the same, that is, to ensure that the licensee-debtor’s estate is maximized for the benefit of all the creditors. Furthermore, as with its treatment of trademarks, bankruptcy law imposes an asymmetry between the licensor and the licensee. In the trademark context, this asymmetry could be explained by the goal of maximizing the value of the debtor’s estate for the benefit of all the creditors. In the copyright context, this explanation is not as cogent. For trademark licenses, the licensor and licensee both have property rule protection for their rights under the license in bankruptcy. For copyright licenses, only the licensee has property rule protection under the license in bankruptcy; thus, the value of the debtor’s estate may not be maximized when the licensor is the debtor.

This last anomaly can be explained by appeal to the goals of trademark and copyright. Trademark law is designed to provide incentives for the creation of distinctive names that denote quality or source of the product. The trademark owner obtains strong property protection in the mark not only to provide incentives for the creation of the mark, but also to protect consumers against confusion or misuse of the mark. Copyright law, on the other hand, is designed to provide incentives for the creation of original works

217. See 15 U.S.C. § 15021 (providing for registration of marks “by which the goods of the applicant may be distinguished from the goods of others”).
and also to protect rights of access to use of the works.\textsuperscript{219} The strong protection given to licensees in bankruptcy is designed not simply to protect the licensee’s rights, but also to protect the consumer’s rights of access to the work, when one of the parties to the license has entered bankruptcy.\textsuperscript{220}

IV. OPTIMISTIC AND PESSIMISTIC NOTES ON INTELLECTUAL PROPERTY VIRTUES AND SECURED CREDIT VICES

This part brings the distinct perspectives of optimists and pessimists into the discussion. Each group’s viewpoint is characterized by how it balances the intellectual property right holder’s interests against the public’s interests. Moreover, the courts’ treatment of optimistic and pessimistic concerns are especially enlightening.

A. Overview of Optimism and Pessimism

Professor Paul Goldstein distinguishes “copyright optimists” from “copyright pessimists.”\textsuperscript{221} The copyright optimists believe that broad rights should be granted to the copyright owner, in order to provide the correct incentives to produce the creative work and to disseminate the fruit of his efforts to the public. This Article adopts the position that a copyright optimist believes in the use of property rules and the resulting market system in order to efficiently balance exclusion rights and access rights. Copyright pessimists, on the other hand, construe the copyright holder’s property right narrowly and believe that the law should provide the minimal

\begin{footnotesize}
\begin{enumerate}
\item[219] See \textit{id.} § 102 (defining “scope of protection”).
\item[220] See Neil Weinstock Netanel, \textit{Copyright and a Democratic Civil Society}, 106 \textit{Yale L.J.} 283, 387 (concluding that “[t]he democratic paradigm posits . . . that copyright should be defined and delimited to engender an information infrastructure populated with a lively interplay of sustained works of authorship”). Always at the background of the “information infrastructure” is the manner in which such an infrastructure is financed. The role of debt finance in creating the works of authorship will feedback on the infrastructure. Thomas Jefferson’s view of debt highlights this interplay. “The future that Jefferson envisioned, the liberal future in the current scholarly shorthand, is thus one in which a purified and truer republicanism prevails, a republicanism not longer at the mercy of the forces of debt and corruption.” \textit{Herbert E. Sloan, Principle and Interest: Thomas Jefferson and the Problem of Debt} 9 (1995).
\item[221] See \textit{Copyright’s Highway}, \textit{supra} note 44, at 24.
\end{enumerate}
\end{footnotesize}
protection necessary to allow the copyright owner to produce the creative work. Pessimists strike a balance between exclusion and access rights with a bias towards access. A liberal standard for fair use coupled with compulsory licenses serves as the tools to promote the dissemination of the copyrighted work, with prices set so that the copyright owner will be able to recoup costs with a fair profit for the investment of his effort.222

Although Professor Goldstein acknowledges the overlap between copyright and trademark, he does not divide the world into trademark pessimists and trademark optimists.223 This exclusion reflects both the narrower scope of trademark law and the more secure legal position of trademark relative to copyright. Trademark covers names, marks, and brands—all identifiers that signal quality and the origin of products. Copyright, on the other hand, covers a range of creative and artistic expression that on one level is purely functional, such as computer programs, and at another level is purely aesthetic, such as films. The content of copyright is deeper and richer than that of trademark; as a result, the access rights are more crucial. Furthermore, trademark law is largely a system of property rules with strong market protection for the trademark owner. The Lanham Act does not have an analogue to the fair use doctrine224 or to the remedy of compulsory licensing that exists under the Copyright Act.

All of which does not mean that the optimists have occupied the field of trademark law. At least in the area of gray markets, a battle rages whose terms are similar to that between copyright optimists and pessimists.225 A gray market is an unauthorized distribution channel for trademarked goods.226 Typically, the market

222. See id. at 20.
223. See discussion supra note 57 and accompanying text (describing the overlap between copyright and trademark).
224. Compare 17 U.S.C. § 107 (enacting the fair use doctrine, which allows the limited use of copyrighted works for certain purposes which do not have any substantial adverse effect on the copyright holders’ rights), with 15 U.S.C. § 110 (stating that the fair use defense is not available under the Lanham Act).
225. See Ghosh, supra note 57, at 375-83.
226. See K Mart Corp. v. Cartier Inc., 486 U.S. 281, 285 (1988) (stating that “a gray market good is a foreign-manufactured good bearing a valid United States trademark, that is imported without the consent of the United States trademark holder”). See
arises internationally, where a foreign entrepreneur buys United States trademarked products manufactured and distributed overseas, and resells the products in the United States through outlets, such as 47th Street Photo, K-Mart, or Sam’s Discount Furniture. Gray markets allow the marked product to be sold to a broader public at a reduced price, often at the expense of the advertising and goodwill developed by the original manufacturer. Just as the issue of access versus exclusion in the copyright arena is divided between optimists and pessimists, the debate over gray markets is divided between trademark universalists and trademark territorialists.227

Trademark universalists, like their cousins, the copyright optimists, believe in global protection for a mark, independent of the source of origin of the products that the mark brands. Universalists believe in protection for the gray market because there is no deception in the use of the mark when the product is sold through an unlicensed distributor to the public. If the product is marked “SONY,” according to the universalists, the mark signals the origin of the product, regardless of whether the product is bought from a gray market outlet in New York or San Francisco’s Chinatown, or from an authorized dealer.228 Trademark territorialists, on the other hand, seek to restrict the gray market on the grounds that a trademark cannot be separated from the underlying goodwill that has been cultivated by the trademark owner. Because the gray market outlet has not expended the goodwill behind the “SONY” label, to take the above example, it would be deceptive for the unauthorized outlet to sell a “SONY” labeled product.229 Therefore, trademark territorialists would support strong property rule protec-


228. See Apollinaris Co. v. Scherer, 27 F. 18, 20 (S.D.N.Y. 1886) (holding that a German importer selling bottled water with the label of a Hungarian manufacturer in the United States did not violate the trademark rights of the Hungarian company because the goods were genuine).

229. See A. Bourjois & Co. v. Katzol, 260 U.S. 689, 692 (1923) (holding that the importer of a French product bearing a United States trademark into the United States violated trademark laws because the product could only be sold with the goodwill of the business).
tion for trademark owners much like copyright optimists would for their bailiwick.\footnote{230}

Because of the parallel positions that exist in the areas of copyright and trademark, it is possible to speak in general of “intellectual property optimists” and “intellectual property pessimists.”\footnote{231} The optimists believe in property rules and markets to secure production and distribution of intellectual property. The pessimists believe in liability rules and a regulated exchange in order to promote access and the limited returns necessary to encourage the creation of the intellectual property. Although optimists and pessimists will have identifiable positions on intellectual property law issues, such as the regulation of the gray market and the scope of the fair use doctrine, they should also have identifiable positions on secured credit. In fact, because of the increased use of copyrights and trademarks in secured credit, and the resulting implications under article 9 and bankruptcy, the implications of the law of secured credit on the policy goals of copyright and trademark deserves greater consideration. To put it bluntly, one must determine how optimists and pessimists view the treatment of trademarks and copyrights under the law of secured credit.


\footnote{231} In light of my previous critique of the common control exception, \textit{supra} note 57, and because this Article appears to support gray marketing, some may question whether I truly am an “intellectual property optimist,” as the title of this Article suggests. My can be explained in two ways. First, the criticisms are solely about the application of the common control exception, which fails to adequately distinguish between licensing and parent-subsidiary relationships, especially because of the view that a firm is in essence a “nexus of contracts.” Second, the international trade aspects of gray marketing add another dimension not adequately explored in the textual discussion of pessimists and optimists. Because promoting gray markets advances free trade, thereby opening international markets, from an international trade perspective, a position in favor of gray markets is consistent with the optimist’s view of intellectual property.
Due to the fragmented nature of the treatment of copyright and trademark under both article 9 and the bankruptcy laws, one would expect that the law would provide something for everyone. And, in fact, the law does just that. Optimists would like the section 365(a) regime under bankruptcy, with its strong property rule protection for trademark licensors, but shudder at the protection given to licensees in bankruptcy to assume a license that may be unprofitable to the licensor. Pessimists would like the protection given to licensees under section 365(n) because it limits the rights of the licensor to deny access and use of the technology within bankruptcy.

Secured credit with the use of trademark and copyright as collateral poses a deeper puzzle for pessimists and optimists alike. On the one hand, by providing a source of finance, secured credit allows for the production of copyrights and trademarks. The copyright or trademark owner can produce his product by shifting some of the risk of creation to a third party via contract. Copyright optimists and pessimists would both appreciate this dimension of secured credit. On the other hand, secured credit gives the creditor a property interest in the intellectual property, allowing the creditor to seize the property in the case of default. Such a scheme would make optimists shudder, as it allows the intellectual property creator to be divested of a property right. Pessimists may cheer because the scheme potentially allows access as the secured creditor may disseminate the work in ways that the original creator may not. The potential delays in disseminating the work, however, would give the pessimists pause, especially in light of the Orion bankruptcy and Spike Lee’s own history.232

The conflict between the optimists and pessimists reflects the diverging distributional goals of the Bankruptcy Code and article

232. See discussion supra notes 14-15 and accompanying text (describing the Orion bankruptcy). See Scott M. Martin & Peter W. Smith, The Unconstitutionality of State Motion Picture Film Lien Laws (or How Spike Lee Almost Lost It), 39 AM. U. L. REV. 59, 61 (1989), for a discussion of Spike Lee’s woes in financing his first major film project, She’s Gotta Have It, using intellectual property as collateral. Spike Lee’s troubles with the law of secured credit illustrate the problem with state lien laws that allow creditors extensive rights to attach the collateral of the debtor in which they have a security interest. In Spike Lee’s case, creditors attached and were threatening to auction off prints and negatives of his work-in-progress. See id. at 63. Martin and Smith argue effectively for the preemption of the state lien laws by the Copyright Act. Id. at 84-87, 91-94.
9. The Bankruptcy Code contains a fresh start procedure that allows individuals escape the contractual prison of debt obligations. Although article 9 is also procedural, it facilitates the formation of contracts by creating immutable rules that provide certainty with regards to recurring disputes. On the other hand, the Bankruptcy Code creates certainty in liquidating, discharging, and restructuring debt. Together, the Bankruptcy Code and article 9 create a property rights system that protects debtors through property rules and allows for the creation and liquidation of debt.

In light of this characterization of the law of secured credit, one would expect that the assessment of intellectual property pessimists and optimists will rest in large part on the identity of the debtor. Intellectual property optimists will support provisions that secure the property right of the intellectual property licensor; pessimists will support provisions that secure the property right of the licensee. Similarly, optimists will support provisions of article 9 that protect the debtor, and pessimists will support provisions that protect the creditor. At one level, the problem of predicting the attitudes of optimists and pessimists toward secured credit is largely one of predicting the identity of the debtor.

B. Case Law in Support of Optimism and Pessimism

The attitudes of optimists and pessimists toward secured credit rests on the predictability and clarity that the law provides. The use of copyrights and trademarks as collateral, though recognized, was not considered when drafting the intellectual property laws or the law of secured credit. Hence, we are left with lacunae in the law, such as the problem of priority disputes between assignees and secured creditors. In order to fill these gaps, one must engage in the tools of statutory interpretation and policy analysis. Interestingly enough, many of the gaps in the law are resolved through private bargaining and negotiation. Despite the lack of clarity in the law, copyrights and trademarks are a significant form of collateral, both quantitatively and in aggregate value. The case for in-

233. See Haemmerli, supra note 11, at 1721; Weinberg & Woodward, supra note 109, at 106.
234. See Haemmerli, supra note 11, at 1651-52.
intellectual property pessimism or optimism may hinge on empirical
issues rather than formal theory. To provide empirical content to
the analysis, this section focuses on the principal cases dealing
with the treatment of copyrights and trademarks as collateral.

1. Support for the Pessimists

A franchisor licenses his trademark and goodwill to a franchi-
see that subsequently goes bankrupt. The franchise agreement sets
out royalty payments, obligations of the franchisor to use its efforts
to maintain the quality of the franchise, and a covenant not to com-
pete by the franchisee. In bankruptcy, the franchisee chooses to
reject the agreement under section 365, but the franchisor wishes
to enforce the covenant not to compete.

One should consider whether the franchisor can enjoin the
former franchisee from competing. For intellectual property opti-
mists, the desired answer would be yes. Even if the former fran-
chisee has no rights in the trademark upon rejection, accumulated
goodwill may persist in the former franchisee’s business, and the
optimists would reason that the former franchisee would diminish
the value of the franchisor’s rights in the mark by using that accu-
mulated goodwill. The pessimists, on the other hand, would seek
to limit the franchisor’s monopoly profits and would favor the dis-
semination of goodwill by not enforcing the covenant not to com-
pete.

On this matter, the intellectual property pessimists can count a
victory in the case In re Rovine Corp.,235 where the court rejected
the franchisor’s argument that the covenant not to compete was
severable from the rest of the license and enforceable against the
franchisee, even upon rejection in bankruptcy. According to the
court, the franchise agreement could only be rejected in its entirety
or not at all. This aspect of the court’s holding is not surprising.
What is more curious, and potentially more troubling for intellec-
tual property optimists, is the court’s reasoning as to the applica-
bility of section 365. The Rovine court reasoned that, if the fran-
chisor did not have outstanding obligations under the agreement,
then the franchisee-debtor would not have the power to reject. Be-

235. 6 B.R. 661 (Bankr. W.D. Tenn. 1980).
cause the franchisor’s continuing obligation was to maintain the
goodwill and reputation of the mark, the court’s reasoning places
franchisors in a bind: Either sacrifice control over the mark and
goodwill making the contract non-executory, and hence, non-
rejectable, or maintain control over the mark and allow the debtor
to reject. In the first instance, the franchisor could enforce the
covenant not to compete; in the second, the franchisor could not.
The court’s reasoning further erodes the franchisor’s property
rights in the trademark. If the franchisor were to sacrifice control,
he runs the risk of abandoning the mark because the license would
become an assignment in gross. On the other hand, maintaining
control limits the franchisor’s ability to enjoin the franchisee from
competition.

Regardless of whether the license agreement is executory, the
franchisee can always terminate the contract. “Executoriness”
makes a difference only in terms of the remedies available to the
franchisor. If the franchisee breaches, even in bankruptcy, the
franchisor will obtain a claim for damages against the franchisee or
his bankruptcy estate. In the event of a breach, however, the cove-
nant not to compete would more than likely be severable, allowing
the franchisor to enjoin the franchisee from continuing his business
as a going concern. Through the application of section 365, the
Rovine court transferred a valuable property right from the franchi-
sor to the franchisee.236

Courts have similarly undermined the property interests of
trademark owners in the context of secured credit. As part of a
bankruptcy reorganization, the trustee sells the debtor’s trademarks
and other assets to a third party. A prior secured creditor inter-
venes to challenge the sale on the grounds that he has a perfected
security interest in the marks. There is no question that the sec-
cured creditor and the debtor had a valid security agreement trans-
ferring an interest in the mark to the creditor as security. Never-
theless, there is a genuine question about perfection. The creditor
filed his interest pursuant to state law governing general intangibles,
but it is unclear where the secured creditor should have filed
his security interest.

236. Id. at 665-66.
In *In re Roman Cleanser Co.*, 237 the court held that a federal filing with the P.T.O. was not necessary and the valid state filing sufficed to perfect the debtor’s interests. 238 The court’s reasoning was based on a reading of section 10 of the Lanham Act, requiring the recording of assignments of trademarks, but not other transfers. 239 Because the court concluded that a grant of a security interest is not an assignment, federal filing is not required to perfect. 240

The court’s rationale is particularly revealing. According to the court (1) Congress could have provided a means for recording security interests in trademarks, but chose not to do so; (2) Congress intended to protect the public from the deceptive use of trademarks; (3) a secured creditor with a security interest in a trademark cannot use the trademark, unless the debtor defaults; thus, (4) security interests in trademarks cannot lead to public deception. 241 The court’s reasoning, however, may be troublesome. “Future assignments,” which would occur if the debtor did default and the secured creditor attached the trademark, are not included in “assignments” under section 10 of the Lanham Act. 242

But, arguably, it is the very contingency of debtor default and subsequent attachment, which makes the granting of a security interest particularly misleading to the public, at least to those who are obtaining presently valid assignments. The result is analogous to the “floating lien,” condemned by the court in *Benedict v. Ratner,* 243 where the problem was one of the separation of ownership and possession. 244 In the trademark context, the problem is one of subdividing the rights of ownership among assignees and creditors with a system of notice that is potentially complex.

The problem is exacerbated by the provision within section 10

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238. *Id.* at 945-46.
239. *Id.*
240. *Id.* at 943-44.
241. *Id.*
242. *See id.* at 946.
244. *See supra* note 60 (describing the “floating lien” problem in *Benedict v. Ratner*).
of the Lanham Act, which determines priority among assignees through a first to file system against subsequent purchasers. The priority rules are consistent with those under the U.C.C., which also adopts a first to file or perfect system, in order to determine priority disputes among secured creditors. As Roman Cleanser indicates, conflicts between assignees and secured creditors will most likely also be resolved through a first to file system. The complication is that section 10 provides a three-month relation-back period for filing, wholly absent from state law. As a result, potential gaps in the law exist.

Intellectual property pessimists should appreciate Roman Cleanser. Although the case seems to permit the use of a floating lien in the context of trademarks, the uncertainty over an assignment of marks raises some doubt about a trademark owner’s ability to assign a mark and obtain full value for the assignment. As a result, a crucial property interest of the trademark owner is reduced in value and scope.

The Roman Cleanser case is not, however, a clear victory for pessimists. If the value of an assignment cuts into the trademark owner’s monopoly profits, then the ability to disseminate the mark and the accompanying access rights are also reduced. One must determine whether the effects of the reduction in the profits of the trademark owner from the transaction is larger than the effects of the reduction in the number of licenses.

There are several reasons to believe that Roman Cleanser may reduce the trademark owner’s profits while not limiting the dissemination or access to the mark. In an ideal world, the floating lien system of secured credit would allow the trademark owner to receive a cash advance on future royalty payments on licenses. If the trademark owner grants a security interest in the marks in exchange for money and the security interest is perfected correctly, then future licensees take the mark subject to the security interest. This subordination would reduce the royalty terms of the future li-

245. See Roman Cleanser, 43 B.R. at 946.
246. Id.
licenses. If markets are working perfectly, then the floating lien is simply a transfer from the future to the present, and there should be no change in the number of licenses. The only difference would be in the timing of the trademark owner’s profits.

Of course, actual licensing and financing arrangements are far from ideal. The secured creditor bears the burden of perfecting his interest. If he fails to do so or does so incorrectly, a subsequent licensee may take over the secured creditor. The risk is shared between subsequent licensees and the secured creditor. Because of this added risk, licensees may be more reluctant to license the trademark and those who do will require lower royalty payments because of the added risk. The franchisor ultimately loses in terms of profits and dissemination of the mark. Although this is clearly not a victory for intellectual property optimists, it is no more than a hollow victory for intellectual property pessimists.

A less ambiguous victory for intellectual property pessimists can be found in the treatment of security interests in licenses held by licensees. In In re Specialty Foods of Pittsburgh, Inc., the court held that licensees of trademarks could use the licenses as security interests. Security creditors could attach the license in case of default by the licensee. The secured creditor, however, had to expressly state in the security agreement with the debtor that the license was the subject of the collateral. As a result, licensees can finance the use of trademarks through secured credit.

Furthermore, secured creditors’ rights will trump the rights of the trademark licensor, presumably the owner of the mark. Because the licensee can assume the license under Rovine, the secured creditor’s interests would attach to the license through bankruptcy. Therefore, the secured creditor would receive priority in assets of the debtor up to the value of the license. Moreover, if the licensee chose to reject, as in Rovine, the secured creditor would be entitled to adequate protection for his security interest. In either case, there is a transfer from the licensor to the secured creditor. The bankruptcy treatment of the licensee’s use of the trademark under a franchise agreement and under a security interest are strong victories for the pessimist camp.

2. Support for the Optimists

Interestingly enough, all of the cases in support of the pessimists involve trademarks. One trademark case that is perhaps an ambiguous victory for the optimists is *In re Lady Madonna*, which involved the use of trade names by the trademark owner as security for a loan. The court held that the secured creditor’s interest in the marks were invalid because of an inadequate description of the marks in the security agreement. As a result, the secured creditor’s interests were unprotected and the trademark owner’s marks were left unencumbered. *Lady Madonna* indicates that all is not lost for intellectual property optimists in the realm of trademarks.

The case for the optimists is somewhat stronger in the realm of copyrights. The case is not as strong as it could be because of section 365(n), which provides licensees of intellectual property, that is, copyrights but not trademarks under the Bankruptcy Code, strong property right protection against licensors. Section 365(n) must be placed in the pessimist camp. But bankruptcy court rulings pertaining to security interests in copyrights offer hope for the intellectual property optimists.

Foremost is the *Peregrine* case, in which the court held that security interests in copyright can be perfected only by a filing with the Copyright Office. The court’s holding rested on the recordation provisions of the Copyright Act, which, unlike the provisions of the Lanham Act, applies to “assignment” and “transfers.” Because the court held that the Copyright Act provided a unified system of recordation that was consistent with article 9, a federal filing was the sole means of perfection. In *In re AEG Acquisition Corp. v. Zenith Productions, Ltd.*, the court extended its holding to cover films and other artistic works that do not have to be registered with the Copyright Office under the Berne Convention for the Protection of Literary and Artistic Works (“Berne Conven-

252. *Id.*
tion") because the terms of the Berne Convention were not self-executing and did not apply to the creation of security interests within the United States.

A unified, federal system of filing for copyright does not run the risk of dividing entitlements and ownership like the separate state and federal filing system for trademarks. As a result, copyright obtains greater property-like protection than trademarks; a clear victory for optimists. The interaction with section 365(n) is exemplified by the recently decided Emplexx case. The debtor, AGI Software Inc. ("AGI"), was a consortium of twenty-five private colleges, collectively owning rights in specialized software designed to aid in university administration. In order to market the software, AGI created a spin-off company called Emplexx with which AGI entered into an exclusive licensing agreement. Under the terms of the agreement, AGI would transfer rights in the software to Emplexx, which would be responsible for marketing and sublicensing, in exchange for a share of the sublicense royalties and the assumption of certain lease and financial obligations of AGI.

A few months prior to the filing of the bankruptcy petition by AGI, Emplexx failed to give adequate assurances that it would guarantee AGI’s financial obligations under the terms of the license. AGI, subsequent to Emplexx’s failure to grant assurances and prior to the petition, granted a software license to a third party. In the bankruptcy proceedings, Emplexx moved to have the trustee assume or reject the AGI-Emplexx license and then assert Emplexx’s rights as licensee under section 365(n).

According to the court, Emplexx failed to provide AGI with adequate assurances and was in breach of the license, therefore, AGI had “effectively terminated the License Agreement pursuant

255. Id.
to its terms." Because of Emplexx’s breach, “[t]here was no agreement for the Trustee to assume or reject, and therefore summary judgment should be entered against Emplexx...” Finally, the court also held that Emplexx could not vacate the automatic stay in order to assert the validity of the license because “there was no valid agreement at the time of the filing of the petition.” Thus, the court continued, “Emplexx is not a secured creditor, and may not seek relief from the stay for lack of adequate protection...”

The AGI case represents a clear victory for the intellectual property licensor and suggests that the pre-petition breach by the licensee may be a way to avoid the section 365(n) regime.

V. EMBEDDING THE INTELLECTUAL PROPERTY LICENSING GAME IN THE BANKRUPTCY GAME: THE LAW AND ECONOMICS OF INTELLECTUAL PROPERTY ACCESS AND SECURED CREDIT

Economic analyses often culminate in what can be called invariance results, which state that certain economic decisions are invariant to some exogenous set of conditions. The use of intellectual property in secured transactions calls into play three types of invariance results. The first is the Coase Theorem, which states that in a world of zero transaction costs, the final allocation of rights will be invariant to the initial distribution rights under the legal system. Very broadly, this result would apply to both the way intellectual property rights are defined and the way rights are

257. Id. at 862.
258. Id.
259. Id.
260. Id.
261. The facts are particularly striking because AGI was the parent of Emplexx and presumably exercised extensive control over its management and governance of Emplexx. The result of the case suggests that license agreements between parents and subsidiaries can be removed from the section 365(n) regime by forcing a breach prior to the filing of a bankruptcy petition by the parent.
262. See, e.g., William G. Shepherd, Potential Competition Versus Actual Competition, 42 Admin. L. Rev. 5, 20 (stating that “exogenous conditions are embedded in the nature of each industry, and they are governed by technology and demand”).
divided between debtors and creditors. The second invariance result is the Modigliani-Miller Theorem, which very broadly states that the value of a company is invariant to whether the company is financed by debt, equity, or a combination thereof. In the secured transaction context, this result would undermine the argument that secured creditors create value in terms of reducing monitoring costs, and would support the view that secured credit is merely a transfer from unsecured to secured creditors. Finally, the third invariance result is the Fisher Separation Theorem, which states that the decision on what goods to produce is independent of how the production is financed. In economic terms, the separation theorem means that the real and financial sectors of the economy are independent of each other. In the context of intellectual property, the separation theorem means that the mix and quantity of intellectual property produced in society is independent of how the project to create the property is financed.

Each of these results are true in a theoretical sense under ideal conditions. The Coase Theorem is true in a world of no transaction costs. The Modigliani-Miller and the Fisher Separation Theorems apply in a world of complete and perfect markets, including financial markets. The role of law is to either create imperfections in the ideal world or to be irrelevant to the final outcome, assuming once again that economic and social conditions are ideal. Of course, the actual world falls short of the ideal conditions. The purpose of these theorems is to aid in analytically identifying the causes of imperfection and the manner in which legal results can facilitate a result that yields efficient trade and bargaining. The three invariance results serve to frame the analysis of the proper treatment of intellectual property as collateral for secured transactions.

Consider first the implications of the Coase Theorem. If the theorem were true, allocating property rights as the right to exclude and the right of access would be unnecessary. Ownership interests in trademarks and copyrights would be held by those who

264. See Modigliani & Miller, supra note 169; see also Ian Ayres, Back to Basics: Regulating How Corporations Speak to the Market, 77 Va. L. Rev. 945, 999 (1991) (discussing the Modigliani-Miller Theorem as it relates to invariance results).
265. See Ayres, supra note 264, at 994.
could use the property most efficiently, regardless of whether the right to exclude or right of access was protected. This conclusion, however, overlooks the problem of whether the intellectual property would be created in the first place.

Suppose that the law protected the right of access. Individuals could copy works as long as damage awards were paid ex post. The potential creator of intellectual property would create a work only if the expected damage awards were greater than the costs of production. A market for licensing the work would not be created because, if parties could procure the work by copying and paying damages, there would be no incentive to obtain a license. As a result, the potential revenues from creating and distributing the work would be diminished. The initial allocation of the property right, either to the creator or to the user, will affect the mix and type of intellectual property that is produced and disseminated.

Now consider the Modigliani-Miller Theorem as applied to financing the creation of intellectual property. For the sake of analysis, assume that the creator of the work incorporates and the sole asset of the newly formed corporation is the intellectual property. According to this theorem, the value of the corporation will be independent of the mix of debt and equity used to finance the creation of the work. If this theorem is true, then it is irrelevant whether the creator uses secured or unsecured debt or equity as the means of financing.

The law of secured transactions and bankruptcy serves only to redistribute wealth from unsecured to secured creditors. The possibility of bankruptcy, however, makes this conclusion untenable. As a firm uses more debt to finance its ventures the probability of bankruptcy also rises; the increase in the probability of bankruptcy reduces the ex ante value of the firm. The value of the firm will depend, nevertheless, not only on the probability of bankruptcy but also on the value of the firm’s assets and liabilities within bankruptcy. Therefore, the substance of bankruptcy law will also affect the value of the firm as evinced by the earlier discussion of section 365. The value of the firm, in short, will not be invariant to the mix of debt and equity used.

Finally, the exceptions to the invariance results affect the invariance between production and finance predicted by the Fisher
Separation Theorem. This last invariance result would predict that the decision on what types and how much intellectual property are produced will be independent of the means for financing the production of such property. The fact that neither the Coase Theorem nor the Modigliani-Miller Theorem is likely to hold in general, and particularly in the case of financing the production of intellectual property, undermines the applicability of the Fisher Separation Theorem. After all, if it matters whether the property right is assigned to the creditor or to the debtor under article 9 and federal bankruptcy law, contra the Coase Theorem, then the production of a copyright or a trademark, for example, will depend upon how the production is financed.

The Spike Lee saga is a perfect example of the failure of invariance. Mr. Lee used the underlying film stock and negatives as collateral for his project; when his creditors attached this collateral, Mr. Lee’s ability to complete and disseminate the creative work was limited. The separation result is also undercut by the possibility of bankruptcy. If the value of the film is affected by the choice of the means of financing, then the ability to finance the project will affect the ability to produce the work. Therefore, the separation result will not apply to the creation of intellectual property.

The failure of the Fisher Separation Theorem to apply has striking implications for both intellectual property law and the law of secured credit. Much of the discussion of intellectual property rights is viewed largely as a question of how to define rights within the intellectual property rights system itself; that is, determining whether the legal regime should protect the right to exclude or the right of access. The answer to this question depends on how the law of secured credit allocates property rights between debtor and creditor and among creditors.

**CONCLUSION**

Intellectual property and secured credit are not irreconcilable—even though the legal regime protecting copyright and trademark is in conflict with the legal regime protecting secured credit arrangements. The inconsistencies that exist regarding the allocation of property rights and the means by which property rights are pro-
ected can be resolved only if we isolate those conflicts between the property rights regimes.

Advocates of article 9 or bankruptcy law reform generally ignore the effects that their reform will have on intellectual property because they address the issue solely from the perspective of the secured creditor or the debtor. That approach is flawed because the success of any reform proposal will depend upon a full understanding of the intricate conflicts between intellectual property law, bankruptcy law, and secured credit law. Accordingly, one’s attitudes toward article 9 and bankruptcy, as well as relevant reform proposals, hinge on whether one is an intellectual property optimist or an intellectual property pessimist.

An optimist would advocate stronger protection of the rights of the intellectual property owner and less for creditors and licensees. A pessimist would advocate the opposite position, heralding a strong, coherent system, which includes (1) guidelines for perfecting security interests, (2) clear rules for determining priority disputes between assignees and secured creditors, and (3) greater property protection for licensees against licensors.

Although the current system has much to encourage and much to upset optimists and pessimists alike, this analysis of both viewpoints suggests that the optimist perspective will generate the most effective reform proposals to reconcile the law of intellectual property with the law of secured credit.