

APPENDIX 18 - SECTION 261 THEORIES OF DISPLACEMENT

Section 261 of the Patent Act can be read to displace all or part of Article Nine under one of three theories. First, if a title transfer is considered a necessary *federal incident* to the creation of a security interest in a patent, in some or all cases, the federal title model may preempt the title neutral concept in Article Nine.¹ Second, a security interest is a protected "purchaser or mortgagee" under section 261, thus giving subsequent secured parties rights against unrecorded patent transferees that they do not enjoy under Article Nine.² Finally, the common law BFP rule (outside section 261) that protects "purchasers" who take legal title to a patent against *equitable* encumbrances is, in fact, federal common law that was never altered by Article Nine's enactment in the various states.³

A. *Preemption and Unrecorded Assignments under the Patent Act*

Whether the Article Nine security interest is an assignment, grant or conveyance that needs to be recorded under section 261, if the security interest is a protected subsequent party, Article Nine's priority rule will yield to the Patent Act anytime a transfer intended for security follows an unrecorded assignment.

This hypothetical involving a priority dispute between a prior unconditional assignee and a subsequent secured party makes the strongest case for the partial preemption of Article Nine.⁴ Section 261 provides that if a patent assignee does not make a proper PTO recording within three months of the executed assignment or prior to the date of any subsequent purchase or mortgage, the assignment is "void" against the subsequent bona fide "purchaser or mortgagee."⁵ Thus, the negative inference under patent law is that the assignee has better rights in the patent than the subsequent purchaser or mortgagee if the assignment is filed first or within three months of its

¹ See discussion PRELIMINARY REPORT #1: AN OVERVIEW OF THE CURRENT LEGAL RULES AND STRUCTURES GOVERNING THE PERFECTION AND PROPERTY OF SECURITY INTERESTS IN INTELLECTUAL PROPERTY AND AN ANALYSIS OF PROPOSED LEGISLATIVE REFORMS at Section III (C)(3) et seq. (Cooperative Contract - U.S.P.T.O. and Franklin Pierce Law Center 2000).

² See discussion in PRELIMINARY REPORT #1, *supra* note 1 at Section III(c)(4).

³ See discussion in PRELIMINARY REPORT #1, *supra* note 1 at Section III(c)(5).

⁴ 35 U.S.C. § 261 (1994).

⁵ *Id.*

execution.⁶ In the case of the prior assignee matched against a subsequent secured party, the prior assignee is squarely within the prior section 261 "assignment, grant or conveyance."⁷ If the secured party is a protected section 261 "subsequent purchaser or mortgagee" as well, then inconsistent Article Nine provisions will yield to section 261 of the Patent Act every time the conflict is so formed. Recent section 261 case law concludes that the "purchaser" protected under section 261 is the same "purchaser" protected under the common law bona fide purchaser rule applied to patents.⁸ As noted earlier in section III(c)(1)(B), the Federal Circuit has recently used the common law bona fide "purchaser" rule to protect an exclusive licensee who took from the legal title holder in a transaction under which the licensor was found to have "retained ownership."⁹ While a third party who takes an interest in less than the exclusive right to make, use and sell may not be protected,¹⁰ a consensual lien on the whole patent would seem to be sufficient as long as a protected "purchaser" does not have to take ownership.¹¹ A secured party will qualify as a protected subsequent "purchaser" under section 261 if the statutory rule covers the same ground as the common law BFP rule applied by the Federal Circuit.¹² As for current state law, a secured party falls within the U.C.C. definition of a "purchaser" in sections 1-201(32)&(33).¹³ If the section 261 reference to a subsequent "purchaser or mortgagee" mimics the common law BFP,¹⁴ the reference may not be as title-sensitive as the "assignment, grant or conveyance" language that measures the recording mandate of the same section.¹⁵ In other words, a secured party

⁶ Why Corp. v. Super Ironer Corp., 128 F.2d 539, 53 U.S.P.Q. 609 (6th Cir. 1942).

⁷ 35 U.S.C. § 261 (1994).

⁸ Heidelberg Harris, Inc. v. Loebach, 1998 U.S. App. LEXIS 11490 at *10-11 (Fed. Cir. June 2, 1998) ("...one who acquires an interest in a patent for valuable consideration from the legal title holder..."); FilmTec Corp. v. Allied-Signal, Inc., 939 F.2d 1568, 1573 (Fed. Cir. 1991) ("*Both the common law rule and the statute* [§ 261] contemplate that the subsequent purchaser be exactly that - a transferee who pays valuable consideration, and is without notice of the prior transfer.") (Emphasis and brackets added).

⁹ 1998 U.S. App. LEXIS 11490 at *2-3.

¹⁰ Weinar v. Rollform, Inc., 774 F.2d 797, 807 (Fed. Cir. 1984); Bailey v. Chattem, Inc., 684 F.2d 386, 392 (6th Cir. 1982)

¹¹ 1998 U.S. App. LEXIS 11490 at *2-3 & *10-11 (Harris was a bona fide purchaser for value of an exclusive conditional license to make use and sell).

¹² *Id.*

¹³ U.C.C. § 1-201(32)&(33). Revised Article Nine is even more specific. U.C.C. [Revised] § 1-201(32)&(33) ("security interest" specifically included).

¹⁴ 939 F.2d at 1573.

¹⁵ See discussion in PRELIMINARY REPORT #1, *supra* note 1 at Section III(c)(1)(C).

seems to qualify as a protected "purchaser" under section 261 of the Patent Act whether the security interest is itself an "assignment, grant or conveyance" that must record or risk avoidance.¹⁶

If the language "subsequent purchaser or mortgagee" in section 261 refers only to the title-bearing mortgagee ancestors of the Article Nine security interest, as some have argued, the recording provisions of section 261 do not preempt Article Nine.¹⁷ If a secured party is a "subsequent purchaser or mortgagee," the applicable section 261 priority rule conflicts with the Article Nine priority provision in section 9-301(1)(d). Article Nine section 9-301(1)(d) provides that an unperfected security interest in general intangibles is subordinate to the right of a transferee who gives value for the rights without knowledge of the unperfected security interest therein.¹⁸

Assuming that U.C.C. section 9-301(1)(d) applies to potential security interests because that do not exist, as well as those that exist but remain unperfected,¹⁹ then state law would award priority to the prior executed assignee whether or not the assignee filed with the PTO.²⁰ Again, under section 261, the secured party would win if the prior assignee failed to record with the PTO prior to the date of the security agreement, or within three months of the executed assignment.²¹ Section 261 should displace the Article Nine priority rule in section 9-301(1)(d) in the case of a prior assignee and subsequent secured party.

1. Non-Statutory Federal BFP

As noted earlier, an Article Nine "security interest" can be viewed as a contingent agreement to assign in the future and thus transfers equitable title to the secured party.²² If a security agreement does create equitable title

¹⁶ 35 U.S.C. § 261 (1994).

¹⁷ If the secured party must qualify as a subsequent "mortgagee," and that word retains its pre-U.C.C. "title" armor, then the protected interests described in section 261 do not include the Article Nine security interest.

¹⁸ U.C.C. § 9-301(d).

¹⁹ The controversy concerning the scope of Article Nine's third-party priority rules is discussed in PRELIMINARY REPORT #1, *supra* note 1 at Section II(e)(2)(B) et seq.

²⁰ See U.C.C. § 9-301(1)(d)("a person who is ... a transferee"). See also U.C.C. [Revised] § 9-317(d).

²¹ 35 U.S.C. § 261 (1994).

²² Note, *Recording Security Interests in Patents: Accepting A Traditional Federal System To Preserve the Policies Of Patent Law*, 2 B.U.J.SCI.&TECH.L. 15 para. 34 & 35 (1996). A present agreement to assign future inventions (as distinguished from a present assignment of future inventions) vests equitable, not legal, title in the assignee.

in the secured party, then under common law principles applied in patent cases a bona fide purchaser of rights from the legal title holder without notice, cuts off the equitable title.²³ If this bona fide purchaser rule survives as some form of "federal common law," then an argument for preemption exists, even if security interests do not fall within the "assignment, grant or conveyance" language of section 261 of the Patent Act.²⁴ However, recent Federal Circuit Court cases seem to trace this common law bona fide purchaser principle to state law as it is applied to the transfer of federally created property.²⁵ Old state common law governing bona fide purchasers in conflict with the equity of secured parties has yielded to Article Nine.²⁶ Under Article Nine the BFP, without actual or inquiry notice, still could not cut off the secured party's right if the secured party properly filed under Article Nine.²⁷

2. Priority

a) Scope of Patent Act Priority Language

Because the rule appears to exclude involuntary transfers, including the judicial lien creditor, only two possible priority conflicts might fall within its language. As some of the case law has suggested, the language can be read to control some or all of the conflicts between security interests in patent rights and assignments of those same rights. If the security interest transfer itself is viewed as "an assignment, grant or conveyance, then the section 261 priority rule might be construed to cover conflicts between secured parties when patent rights are the subject collateral.

Arachnid, Inc. v. Merit Indus., Inc., 939 F.2d 1574, 1580-81 (Fed. Cir. 1991). A prior assignor with the right to have the assignment rescinded for fraud has equitable, not legal, title prior to the actual court ordered rescission. *Heidelberg Harris, Inc. v. Loebach*, 1998 U.S. App. LEXIS 11490 at *10-11, 46 U.S.P.Q.2d 1948 (Fed. Cir. 1998).

²³ 1998 U.S. App. LEXIS 11490 at *10-11; *FilmTec Corp. v. Allied-Signal, Inc.*, 939 F.2d 1568, 1573 (Fed. Cir. 1991).

²⁴ 35 U.S.C. § 261 (1994).

²⁵ The *FilmTec* Cir. Court cites to *Hendrie v. Sayles*, [98 U.S. 546, 549 (1879)] for the proposition that a prior equitable encumbrance is cut off by a bona fide purchaser. *See* 939 F.2d 1568 at 1537. *Heidelberg Harris, Inc.* in turn relies on *FilmTec*. i.e. 1998 U.S. App. LEXIS 11490 at *10. The Supreme Court's pre-Erie decision in *Hendrie v. Sayles* relies on state law principles of derivative title and bona fide purchaser status rather than any uniquely federal policy. *See* 98 U.S. 546 at 551-52. *See also In re CFLC, Inc.*, 89 F.3d 673, 678-79 (applies federal common law where it is important to preserve federal patent policy).

²⁶ U.C.C. § 9-203, cmt. 5.

²⁷ U.C.C. § 9-301(1)(d). *Accord* U.C.C. [Revised] § 9-317(d).

b) Secured Party vs. Assignee

Even if the security interest transfer is not an assignment, grant or conveyance that must be recorded under section 261, a subsequent secured party has a strong claim to the status of a "subsequent purchaser or mortgagee" who *may* be protected against prior assignments that must record within three months of execution.²⁸ This section 261 protection for the Article Nine secured party comes with several qualifying limitations.

First, in order to have priority, the later security interest must be "without notice" and "for valuable consideration."²⁹ The "valuable consideration" requirement has already been discussed in the context of the Copyright Act limits on the protection against unrecorded transfers afforded to subsequent interests.³⁰ A subsequent security interest taken to secure an antecedent debt may not qualify. A second hurdle to the subsequent secured party's priority is the "without notice" requirement in section 261. The "notice" referred to in section 261 is broader than actual notice. As it includes constructive and inquiry notice as well.³¹

Whenever a prior assignee does not record within the three-month period, the BFP secured party has priority as long as the security agreement attaches before any late recording by the assignee. Unlike under section 205(d) of the Copyright Act, recording is not relevant to the subsequent party's section 261 rights against a prior unrecorded assignment.³²

Even when the subsequent secured party gives new value and cannot be chargeable with notice, section 261 presents major problems as a priority rule. Because of the three-month look-back any secured party is vulnerable to a potential prior unrecorded assignment for that time. As further complication assignments sent to the PTO are deemed "recorded" under section 261 from the time of "receipt," not from the time they are available for inspection.³³ The "office delay" which occurs between receipt of a recordable document and its availability to the searcher may be as much as two months.³⁴ Therefore, a subsequent secured party who gives new value and takes without notice is still not safe relying on the state of the PTO

²⁸ See discussion in PRELIMINARY REPORT #1, *supra* note 1 at Section III(c)(4).

²⁹ 35 U.S.C. § 261 (1994).

³⁰ See discussion in PRELIMINARY REPORT #1, *supra* note 1 at III(b)(3)(E).

³¹ *FilmTec Corp. v. Allied-Signal, Inc.*, 939 F.2d 1568, 1574, 19 U.S.P.Q.2d 1508, 1512-13 (Fed. Cir. 1991); *Katz v. Lear Siegler, Inc.*, 29 U.S.P.Q.2d 1450, 1453 (Fed. Cir. 1993) (unpublished).

³² Compare 35 U.S.C. § 261 (1994), with 17 U.S.C. § 205(d) (1994).

³³ See 37 C.F.R. § 3.51 (1994).

³⁴ See discussion in Preliminary Report #1, *supra* note 1 at Section III (a).

record until the three month look-back and the office delay period both pass.

The case in which a true assignment, grant or conveyance pre-dates a security interest is the best example of the Patent Act's displacement of the priority rules in Article Nine.³⁵ However, as the discussion in Section III(c)(3) et seq. explains, the case law to date opines that federal recording may also be critical when the security interest is executed *before* a competing assignment.³⁶

When the security interest is executed before a competing assignment, section 261 permits a much more generous time frame for recording than the otherwise applicable Article Nine rule in U.C.C. section 9-301(1)(d). Under section 9-301(1)(d), the secured party would lose to the subsequent purchaser of a general intangible if the purchaser "gives value without knowledge of the security interest and before it is perfected."³⁷ That same secured party prevails against a subsequent patent assignee who takes without knowledge as long as the secured transaction takes title-bearing form (e.g., conditional assignment) and is recorded in the PTO within three months of "its date."³⁸ Of course, a secured party does not know if it is prior or subsequent with respect to its own executed documents. The Patent Act poses an awkward recording and priority vehicle for lenders.

If the prior secured transaction takes the form of a security interest and is recorded with the PTO as a discretionary document,³⁹ it will provide inquiry notice to all who resort to the PTO file under the designated patent number or application number.⁴⁰ Therefore, in many cases, the filing of a security agreement will have the same priority effect as the filing of a conditional assignment. However, only the constructive notice assured by section 261 in the case of title-bearing "assignments" will bind those creditors and purchasers who do not resort to the record.⁴¹ A subsequent assignee of a patent or patent application who did not check the PTO file

³⁵ See discussion *supra* in PRELIMINARY REPORT #1, *supra* note 1 at Section III(c)(4).

³⁶ See 83 B.R. at 782; 48 B.R. at 639. *But see* Holt v. United States, 13 UCC 336, 339 (U.S. Dist. Ct., D.C. 1973); Tollinger v. Ithaca Gun Company, Inc., 555 N.Y.Supp. 2d 908, 910-11 (App. Div. 3d Dept. 1990).

³⁷ U.C.C. § 9-301(1)(d).

³⁸ "Its date" is usually but not always the document execution date. 37 C.F.R. § 3.21.

³⁹ The mandatory cover sheet must refer to the specific patents by patent or application number. See 37 C.F.R. § 3.11 & § 3.31 (1997).

⁴⁰ Security interests are equitable interests that encumber the legal title to a patent. These interests survive a subsequent assignment if the assignee is on inquiry notice that the equitable interest exists. See *FilmTec Corp. v. Allied Signal, Inc.*, 939 F.2d 1568, 1573-74, 19 U.S.P.Q.2d 1508 (Fed. Cir. 1991).

⁴¹ See discussion in PRELIMINARY REPORT #1, *supra* note at Section III(c)(1)(C).

before the transfer would not be on inquiry notice and would not take subject to the security agreement. Although such a subsequent assignee would usually resort to the record, not all creditors do.

c) Secured Party vs. Secured Party

The logic of extending both the “assignment, grant and conveyance” language and the “purchaser or mortgagee” language to cover secured parties leads to the conclusion that section 261 also preempts the Article Nine rules on priority between secured parties.⁴² Instead of determining priority based on the first-to-file⁴³ a proper financing statement, the first secured party to take an assignment of an existing patent or patent application will prevail as long as that party records under section 261 within three months, or before a transfer to the subsequent secured party.⁴⁴ Remember, the prior secured party’s interest cannot be recorded until a patent application is either executed or filed.⁴⁵

A subsequent secured party need not record at all, but can only prevail when the prior party remains unrecorded after the grace period and is unrecorded at the time the subsequent secured party’s interest attaches. Even then, the subsequent secured party will not prevail unless it is bona fide and for “valuable consideration.”⁴⁶

The bona fide or “without notice” qualification has an interesting wrinkle that could arguably restore some significance to Article Nine filing when the priority conflict is between secured parties. Under section 261, notice includes “constructive notice” and “inquiry notice” as well as “actual notice.”⁴⁷ But, constructive notice cannot refer to 261 recording of an assignment because that would be redundant. A prior recorded

⁴² *But see* Weinberg & Woodward, *Easing Transfers, and Security Interest Transactions and Intellectual Property: An Agenda for Reform*, 79 KY. L. REV. 61, 67 n. 27 (1991).

⁴³ U.C.C. § 9-312(5)(a).

⁴⁴ 35 U.S.C. § 261 (1994). The date of the assignment is not always the document date. *See* discussion in PRELIMINARY REPORT #1, *supra* note 1 at footnote 529.

⁴⁵ The application number must normally be included. However, “[i]f an assignment is executed concurrently with, or subsequent to, the execution of the patent application, but before the patent application is filed, it must *identify the patent application by its date of execution, name of each inventor, and title of the invention* so that there can be no mistake as to the patent application intended”. 37 C.F.R. § 3.21 (1997)(Emphasis added.).

⁴⁶ 35 U.S.C. § 261 (1994). *See* *FilmTec Corp. v. Allied Signal, Inc.*, 939 F.2d 1568, 1573-74, 19 U.S.P.Q.2d 1508 (Fed. Cir. 1991).

⁴⁷ *Id.*

assignee/secured party prevails over a subsequent taker by express proviso.⁴⁸ If "constructive notice" could include a preempted Article Nine filing a prior unrecorded secured party might take priority over a subsequent taker if the secured party had filed a financing statement. Although the patent cases on "notice" are very broad,⁴⁹ they probably cannot support such an extension. The logic of such a constructive notice holding would force all subsequent parties, not just secured parties, to check the appropriate state file as well as the PTO records - thus defeating the policy behind a partial preemption.

If a secured party is a section 261 protected "purchaser or mortgagee," the Article Nine concept of notice filing between secured parties would seem to be completely preempted under the *Otto Fabric* and *Transportation Design* interpretation of section 261, because a security interest would have to be formed as a present "conditional" assignment, and recorded.⁵⁰

In addition, after-acquired patent property would be a problem under section 261. Under Article Nine, priority between secured parties in after-acquired property goes to the first to file.⁵¹ If section 261 preempts Article Nine, priority goes to the first title-bearing assignment, if properly recorded within the grace period. A proper recording cannot occur, however, until the application is either executed or filed.⁵² Once the assignment of an application is properly recorded, the assignment will be applied against patents granted from the application including patents granted from divisional applications⁵³ and continuation applications.⁵⁴ Patents granted from continuation in part applications⁵⁵ and substitute applications⁵⁶ will not follow a recorded assignment of the original application, however, because the original only gives the assignee rights to subject matter common to both

⁴⁸ "...unless it is recorded...prior to the date of such subsequent purchase or mortgage." 35 U.S.C. § 261 (1994).

⁴⁹ See *FilmTec Core v. Allied Signal, Inc.*, 939 F.2d 1568 at 1573-74.

⁵⁰ See discussion in PRELIMINARY REPORT #1, *supra* note 1 at Section III(c)(3)(C) et seq.

⁵¹ See U.C.C. § 9-312(5)(a) & cmt. 4.

⁵² See 37 C.F.R. § 3.21 (1997).

⁵³ 35 U.S.C. § 121 (1994); 37 C.F.R. § 1.53, § 1.60 & § 1.62 (1997). See also Manual of Patent Examining Procedure [MPEP] § 201.06 (1998).

⁵⁴ See 37 C.F.R. § 1.53, § 1.60 & § 1.62 (1997); MPEP, *supra* note 53 at § 201.07. "In the case of a division or continuation, a prior assignment recorded against the original application is applied to the division or continuation application because the assignment recorded against the original application gives the assignee rights to the subject matter common to both applications." MPEP, *supra* note 53 at § 306.

⁵⁵ 37 C.F.R. § 1.53 & § 1.62 (1997). See also MPEP, *supra* note 53 at § 201.08.

⁵⁶ MPEP, *supra* note 53 at § 201.09.

applications.⁵⁷

A debtor with only equitable title in a patent or patent application may have sufficient "rights in collateral" for Article Nine attachment purposes,⁵⁸ but a present assignment of only equitable rights does not bring the secured party/assignee within the constructive notice scope of section 261.⁵⁹ Similarly, an assignment of a security interest is only a discretionary document unless it is accompanied by an assignment of all the debtor's right title and interest, subject to a condition subsequent of defeasance when the secured debt is paid.⁶⁰

Transportation Design is an example of a case where the debtor granted the secured party an interest in after-acquired patents. Under Article Nine, the secured party's prior filing of a financing statement naming the collateral by type provides priority against any later security interest even as to property not yet in existence.⁶¹ That priority would not be available under the preempting provisions of section 261 of the Patent Act. Instead, priority would attach to the first interest created and its progeny, but only if there is an existing application to record.⁶² This limitation on the capacity of section 261 to function as a notice filing statute puts an intolerable burden on the financing of ongoing research and development.

⁵⁷ MPEP, *supra* note 53 at § 306. Compare this extension with the more limiting concept of Article Nine "proceeds." See discussion in PRELIMINARY REPORT #1, *supra* note 1 at Section II(c)(2).

⁵⁸ See discussion in PRELIMINARY REPORT #1, *supra* note 1 at Section II(b)(3)(A).

⁵⁹ See discussion in PRELIMINARY REPORT #1, *supra* note 1 at Section III(c)(1)(C).

⁶⁰ See, e.g., Agreement Between Precision Engine Products Corp. and Bank of New York - Grant of Security Interests (Patents), PTO ASSIGNMENT BRANCH RECORDS Reel/Frame No. 7297/0185 (Recorded: Feb. 10, 1995).

⁶¹ See U.C.C. § 9-204(1); U.C.C. [Revised] § 9-204(a).

⁶² See 37 C.F.R. § 3.21 (1997).