APPENDIX 20 - RECENT PATENT ACT PREEMPTION CASES

A. Transportation Design

In re Transportation Design & Technology, Inc.[1] holds that an Article Nine local filing is effective to perfect a security interest in patent collateral against the bankruptcy trustee asserting lien creditor status under section 544(a)(1) of the Bankruptcy Code.[2] As part of this holding, the Court observed "the grant of a security interest is not a *conveyance* of a present ownership right in the patent and, . . . is not required to be recorded in the Patent Office."[3] However, *dicta* in the opinion makes the case for a "partial" priority preemption. *Transportation Design* relies on *Waterman v. Mackenzie* for the following conclusion: ". . . a bona fide purchaser holding a duly recorded conveyance of the ownership rights in a patent or a mortgagee who has recorded its interest as a transfer of title with the Patent Office will defeat the interests of a secured creditor of the grantor or mortgagor who has not filed notice of its security interest in the Patent Office."[4]

Apparently, the Court, relying on *Waterman v. Mackenzie* finds the basis for a narrow preemption of both the *filing and priority rules* in Article Nine whenever the rights of an assignee or titled mortgagee, that has recorded, are in conflict with the ordinary security interest.[5] Under section 261, if a prior assignee (or conditional assignee) fails to record within three months, it must record before the *execution* of a subsequent purchase or mortgage in order to prevail over such subsequent interest.[6] The above quote from *Transportation Design* notwithstanding, as long as the subsequent purchase or mortgage is *bona fide* it need never record in order to assert priority over the prior unrecorded assignment. If the secured party is

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1 48 B.R. 635 (Bankr. S.D. Cal. 1985).

2 11 U.S.C. § 544(a)(1) (1994).

3 48 B.R. at 638.

4 48 B.R. at 639.

5 As noted in Preliminary Report #1, there is a strong argument that neither section 261 nor *Waterman v. Mackenzie* support the "partial preemption" priority rule the Court proposes. *See* discussion in PRELIMINARY REPORT #1: AN OVERVIEW OF THE CURRENT LEGAL RULES AND STRUCTURES GOVERNING THE PERFECTION AND PRIORITY OF SECURITY INTERESTS IN INTELLECTUAL PROPERTY AND AN ANALYSIS OF PROPOSED LEGISLATIVE REFORMS at Section III (C)(3)(B) (Cooperative Contract - U.S.P.T.O. and Franklin Pierce Law Center 2000).

6 35 U.S.C. § 261 (1994).

assumed to be prior in time under the dicta in *Transportation Design*, then it must record its interest in the Patent Office. However, unless the security interest is recorded as a title document, it will not fall within the constructive notice mandate of section 261.[7] Therefore, the conclusion when *Waterman v. Mackenzie* is applied is that one must create a security interest by assignment to assure priority vis-a-vis a subsequent assignee. *Waterman v. Mackenzie* is not dead![8] The alternative of filing an ordinary security agreement (a possible construction of the *Transportation Design* dicta) with the PTO as a discretionary document may provide "inquiry notice" to those who access the file, but it will not be statutory constructive notice to all. Despite the confusing dicta in *Transportation Design*, the Patent Act seems to require a title document for constructive notice purposes and, while the bona fides of the subsequent party are relevant under section 261, recording by the subsequent party is not.[9]

Transportation Design fashions an approach to partial preemption that departs from the partial and full step-back concepts contained in Article Nine.[10] Under the two-stage deferral approach suggested by Article Nine, the first question is whether recording in the Patent Office was a complete and exclusive substitute for Article Nine filing under section 9-302(3)(a)&(4). If

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7 If the secured party took and recorded a security agreement instead of a title-bearing conditional assignment, it would not get the absolute record protection afforded a recorded conditional assignment. In the parlance of the Patent Act, a "security agreement" would convey a "lesser" equitable right to the secured party that would not qualify as an "assignment, grant or conveyance" subject to section 261. 239 B.R. at 920-21; 48 B.R. at 639. However, the "without notice" condition for bona fide purchaser status in 261 protects even equitable interests when the subsequent purchaser is chargeable with "inquiry notice" of the equitable right. Hendrie v. Sayles, 98 U.S. 546, 549 (1879); FilmTec Corp. v. Allied-Signal, Inc., 939 F.2d 1568, 1573 (Fed. Cir. 1991). Those who searched the patent record after the discretionary recording of a security agreement should take subject to the security interest created thereby. Because some actual knowledge may be necessary to trigger inquiry notice, those foolish subsequent purchasers who buy without resort to the record, as well as subsequent involuntary takers such as lien creditors who never rely on the record, may not be subject to the prior "security agreement" recorded only with the PTO.

8 "[W]here a federal statute, such as the Patent Act, governs one area or interest which the secured creditor wishes to protect (e.g., ownership), then the federal statute pre-empts any other method of protecting that interest and is conclusive on the manner of protecting that interest. In other words, if the secured creditor wishes to protect itself against the debtor transferring title to the patent to a bona fide purchaser or mortgagee who properly records, then the secured creditor must bring its security interest (which is not ordinarily a transfer of title) within the provisions of the Patent Act governing transfer of title to patents." 48 B.R. at 639-40.

9 *Id.*

10 *See* discussion in PRELIMINARY REPORT #1, *supra* note 5 at Section II(f).

the Patent Act "provides for a national registration" within the meaning of section 9-302(3)(a), then Article Nine filing is neither "necessary *or effective*.[11] "Compliance" with the federal statute then becomes the exclusive method of "perfection" under section 9-302(4).[12] Section 9-302 makes no provision for the *partial displacement* of the Article Nine filing provisions. If the filing rules are displaced as a mode of perfection by operation of section 9-302, they are displaced in *all* cases where perfection is important to priority.[13] However, because *Transportation Design* ignored the section 9-302(3)(a) approach, the preliminary issue of "national registration" for security interests under the Patent Act is never *directly* addressed. Instead, the Court decides half of the section 9-302(3)(a) issue *indirectly* by concluding that state "perfection" works at least against the lien creditor under U.C.C. section 9-301(1)(b).

While preemption, even partial preemption, is federal law and operates apart from Article Nine notions, the jerry-built "partial filing and priority preemption" theory in the *Transportation Design* dicta is troublesome. It may not be a reliable guide to the scope and function of the priority rule in section 261 of the Patent Act.[14]

B. Chesapeake Fiber

Even though the dicta in *Transportation Design* is flawed, it has had some influence. Relying on *Transportation Design*, the U.S. District Court for the District of Maryland in *Chesapeake Fiber Packaging Corp. v. Sebro Packing Corp.*[15] applied section 261 to resolve a challenge by the original assignor of a patent application to the security interest held by the bankrupt assignee's secured party. The assignor argued that the secured party was unperfected without a PTO recording and thus subordinate to the assignor whose subsequent "reacquisition" made it a protected section 261 purchaser.[16] The Court in *Chesapeake Fiber* found for the secured party only because the original patent assignor could not qualify as a subsequent section 261 "purchaser," not because section 261 did not apply.[17]

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11 U.C.C. § 9-302(3)(1st sentence) (Emphasis added.).

12 U.C.C. § 9-302(4).

13 *Id.*

14 *See* discussion in PRELIMINARY REPORT #1, *supra* note 5 at text accompanying footnote 591 to 600.

15 143 B.R. 360, (D. Md. 1992), *aff'd*, 8 F.3d 817 (4th Cir. 1993).

16 143 B.R. at 368.

17 143 B.R. at 369. Arguably, the assignor could have protected its rights in the assigned patent with a security interest that might have qualified for purchase-money priority. See

C. Otto Fabric

Three years after *Transportation Design*, the United States District Court for the District of Kansas held that a security interest in a patent was "perfected" against an imaginary lien creditor from the time it was properly filed under Article Nine, rather than from the time it was recorded with the Patent Office. The holding in *City Bank and Trust Co. v. Otto Fabric, Inc.*[18] is also accompanied by dicta that sends a mixed message about the scope of federal preemption.

Unlike *Transportation Design*, the moment of "perfection" was important in *Otto Fabric* because it was triggered/controlled by the Bankruptcy Code. Under section 547(e)(2) of the Bankruptcy Code, "perfection" marked the "deemed" date of the security transfer for purposes of the 90-day period for avoiding preferences.[19] Except for the issue of *when* it was "deemed" to have occurred, the transfer for security in *Otto Fabric* satisfied all the other requirements for a preference that was avoidable by the bankruptcy trustee under section 547(b) of the Bankruptcy Code.[20] If the transfer date was marked by the local U.C.C. filing, it would *not* be avoidable because it would fall *outside* the 90-day pre-petition "preference period" in section 547(b)(4)(A).[21] If perfection was marked by the later federal PTO recording, however, the security transfer would be avoidable because it would fall *within* the 90-day preference period.

The *Otto Fabrics* Court held that state law and the secured party's Article Nine filing applies conclusively, *but not exclusively*, to resolve the question of "perfection" in favor of the secured party. Alternatively, the Court held that if the Patent Act did preempt "the field of filing," section 261 offers no protection for lien creditors or trustees invested with lien creditor status.[22]

As in *Transportation Design*, the *Otto Fabrics* Court ignored the Article Nine structure that conceives of a partial deferral as a "filing" deferral under U.C.C. section 9-302(3)(a) and (4). While federal preemption need not follow the guidelines suggested in the preempted state statute, the

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the prior discussion of this aspect of the *Sebro* case *supra* at note 476. *See, e.g.*, Haraway v. Burnett, 1997 Tenn. App. LEXIS 611 at *2-3, 33 UCC2d 1256 (1997)(Assignor of patents retains security interest in them to secure assignee's obligation to make sales contract and royalty payments).

18 83 B.R. 780, 7 U.S.P.Q.2d 1719, 5 UCC2d 1459 (D. Kan. 1988).

19 11 U.S.C. § 547(e)(2)(B)& (e)(1)(B).

20 83 B.R. at 782.

21 11 U.S.C. § 547(b)(4)(A) (1994).

22 83 B.R. at 782.

Otto Fabrics approach seems tied to three inconsistent conclusions.

The first flawed conclusion in *Otto Fabric* is that a PTO recording would be equally as effective as an Article Nine filing to defeat the hypothetical lien creditor under state law.[23] The second flawed conclusion is that if section 261 of the Patent Act "completely preempted the field of filing" its substantive provisions would leave the lien creditor, who could have priority under Article Nine, with no federal law basis for priority against the secured party.[24] Finally, testing the complete opposite thesis, the Court observed that a security interest is not a conveyance of title or ownership rights under the recording mandate of section 261.[25]

As to the Court's first observation on the applicable state law, the filing deferral rules in U.C.C. section 9-302(3)(a) and (4) *do not* comprehend double recording. If the Patent Act recording displaces under section 9-302(3)(a), it displaces completely under section 9-302(4). On the other hand, if the Patent Act did not create a national registry, which supplants Article Nine for "perfection" purposes, filing with the PTO would not protect against the lien creditor, at least under state law.[26] On the federal side, no reasonable take on the language of section 261 would allow the secured party to "perfect" its interest against the involuntary lien creditor by recording in the Patent Office.[27] Involuntary transfers are not even mentioned in the text of section 261. If a section 261 recording did provide priority against the involuntary lien creditor under federal law, state law covering the same ground would surely be preempted and a U.C.C. filing would not even be an alternative way to gain priority over the lien creditor.

This observation about the narrow field of play in section 261 leads to the Court's second flawed conclusion. If federal law did in fact control, the Court concluded that it would leave the lien creditor without any statutory priority. Any hypothesis based on complete preemption by section 261 seems an unlikely alternative holding. Assuming the Court's reference to complete preemption of the "field of filing" really envisions complete preemption of Article Nine, then it may be true that section 261, does not require recording to defect the lien creditor. But as *Peregrine* felt compelled

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23 After upholding U.C.C. based perfection against the lien creditor, the court volunteers the statement that "*recording an assignment* [in the PTO] would also protect the assignee against the claims of a subsequent lien creditor." 83 B.R. at 782.

24 83 B.R. at 782.

25 83 B.R. at 782-3.

26 "Perfection" here means the time when the transfer beats the lien creditor under section 547(e) of the Bankruptcy Code. 11 U.S.C. § 547(e)(1)(B) (1994). *See* U.C.C. § 9-301(1)(b); U.C.C. [Revised] § 9-317(a)(2).

27 35 U.S.C. § 261 (1994).

to conclude,[28] complete federal preemption of Article Nine can hardly be mandated unless the displacing federal recording scheme acknowledge/recognizes lien creditors.[29]

At the other extreme, the title-related dicta in *Otto Fabric* deals even the partial preemption theory a final blow. Emphasizing the theory's "partial" nature, the Court noted that a security interest is not like a collateral assignment. Relying on *Holt v. U.S.*,[30] the Court used the following language to conceptualize the creditor's security interest:

"To require a federal filing and thus a collateral assignment to perfect a security interest in a patent seems inconsistent with the modern notion that a grant of a security interest need not include the conveyance of title or ownership rights."[31]

Of course, the problem with this statement is that it goes too far in describing the "partial" nature of the preemption. Once the security interest is placed outside the "assignment grant or conveyance" language in section 261, the secured party's priority even as against subsequent purchasers and mortgagees would be controlled by Article Nine, not by the federal Patent Act.

As was the case with *Transportation Design*, *Otto Fabric* seemed to base its holding on a patchwork notion of "partial preemption." Once again, the Court's attempt at guidance in the dicta is very confusing.

D. Cybernetic Services

In re Cybernetic Services, Inc.,[32] a recent decision from the Ninth Circuit Bankruptcy Appellate Panel, follows the lead of both *Transportation Design* and *Otto Fabric* in concluding that Article Nine perfection is sufficient against the lien creditor. Here again, however, the Court's dicta touched on priority between the assignee and the secured party and paints an uncertain picture of this priority contest. Although the Court observed that a security interest is not the kind of title-bearing transfer envisioned by the "assignment, grant or conveyance" language in section 261, it also agreed with *Transportation Design* that an assignee would defeat a secured creditor

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28 116 B.R. at 205.

29 Revised Article Nine purports to limit any federal statute that would displace the U.C.C. filing provisions to a statute "whose requirements for a security interest's obtaining priority over the rights of a lien creditor with respect to the property preempt...." U.C.C. [Revised] § 9-311(a)(1).

30 Holt v. U.S., 13 UCC 336, 338-39 (U.S. Dist. Ct. D.C. 1973).

31 5 UCC2d at 1463.

32 239 B.R. 917 (9th Cir. B.A.P. 1999).

"who has not filed notice of its security interest in the Patent Office."[33]

E. Summary of Preemption Cases

If we focus on the narrow holdings of the four cases discussed above, *Cybernetic Services*, *Otto Fabric* and *Transportation Design* all arguably stand for the proposition that the Patent Act *does not* render an Article Nine filing for "perfection" ineffective against the lien creditor. For purposes of Bankruptcy Code avoidance and preference law, this is the critical issue. In that contest, local Article Nine filing controls on both the perfection and the priority issue. Although *Otto Fabric* is not as clear as either *Transportation Design* or *Cybernetic Services* on what *may be* preempted by section 261, all three cases indicate that the secured party must record a security transfer, in title form, under section 261 of the Patent Act in order to defeat a subsequent purchaser or mortgagee.[34] Despite this overrated reliance on *Waterman v. Mackenzie*,[35] this limited Patent Office recording requirement will likely prevail as a matter of transactional policy. Courts are and should be concerned about the integrity of the Patent Office files. The PTO file is relied on by potential buyers or assignees who need to know the state of a patent title. If a security interest must, in the context of subsequent title takers, be formed into some title-bearing assignment, then potential buyers and assignees are relieved of the burden of searching undetermined state U.C.C. files before safely acquiring an ownership interest in a patent. Given the level of uncertainty, a cautious lender must do it both ways, at least for now. Prudence suggests that the secured party file a "financing statement" under state law and also requires that the debtor execute a "title" document that can be recorded in the Patent Office as either a patent mortgage or a conditional assignment.

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[33] 239 B.R. at 920-21 & n.8.

[34] 239 B.R. at 920, n.8; 83 B.R. at 782; 48 B.R. at 639.

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