

# Bankruptcy

COMMENTARY

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## The 'Belt and Suspenders' of Copyright Perfection

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As the credit market tightens and a wave of bankruptcy filings looms on the horizon, creditors would do well to protect themselves to the largest extent possible. At the same time, potential and actual debtors need to be aware of the true reach of any security interest in their assets.

Copyrights are one type of assets to which secured creditors and debtors must pay particular attention in this time of financial uncertainty, especially because the law remains unclear as to the proper method and place for perfecting security interests in certain types of copyrights and their related assets.

Creditors and their counsel should consider whether to perfect their security interests in copyrights and copyright-related assets with both the relevant secretary of state's office and the U.S. Copyright Office — the "belt and suspenders" approach.

### Copyright Assets

The Copyright Act defines copyrights as "original works of authorship fixed in any tangible medium of expression, now known, or later developed, from which they can be perceived, reproduced or otherwise communicated, either directly or with the aid of a machine or device."<sup>1</sup> Such works include literary, musical, dramatic choreographic, pictorial, graphic, sculptural and architectural works as well as films and sound recordings.<sup>2</sup>

When perfecting a security interest, certain related assets are at stake in addition to the copyright, including the actual inventory of copyrighted work and the accounts receivable and royalties generated by the copyrights.

### Registered Versus Unregistered Copyrights

The U.S. Copyright Office maintains a copyright registry, including any transfers of the listed copyrights.<sup>3</sup> One of the effects of registering the copyright is that the federal

courts then have jurisdiction over a case involving the copyright.<sup>4</sup>

Additionally, certain remedies are only available to registered copyright owners.<sup>5</sup> Another benefit is that the copyright owner has given notice of his ownership interest in the copyright.<sup>6</sup> However, the owner does not have to register a copyright since unregistered copyrights are still enforceable.<sup>7</sup>

### Where Should a Creditor Perfect Its Security Interest?

The status of the law on this issue is not fully settled and depends, in part, on the type of copyright assets involved. The Copyright Act essentially provides that in order for a creditor to perfect its interest in a registered copyright, it should file a notice of transfer or copyright mortgage with the Copyright Office.<sup>8</sup> The purpose is to give constructive notice to "all persons" of the transfer.<sup>9</sup> The Copyright Act, however, does not address unregistered copyrights.

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***A savvy secured creditor will both file a financing statement with the secretary of state and document the transfer with the Copyright Office.***

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In a 1990 case of first impression regarding this matter, *In re Peregrine Entertainment*, the U.S. District Court for the Central District of California reviewed the issue of where to perfect a security interest in a copyright: the Copyright Office or the office of the relevant secretary of state.<sup>10</sup>

In that case the creditor had filed a financing statement with the secretary of state's office concerning a library of copyrights and what the court described as related

accounts receivable.<sup>11</sup> The creditor did not file anything with the Copyright Office.

The District Court considered whether Article 9 of California's Uniform Commercial Code provided a parallel method of perfecting a security interest in a copyright.<sup>12</sup> The UCC allowed for the perfection of security interests in general intangibles, including copyrights, by the filing of a financing statement with the secretary of state's office.

However, the court determined that the Copyright Act's recording provisions and unique federal interests supported the determination that federal law preempts state law when perfecting a security interest in copyrights and related accounts receivable.<sup>13</sup>

One of the arguments persuasive to the court was that the incorporeal nature of copyrights meant that any number of states could be the correct one in which to file a financing statement.<sup>14</sup> Another difficulty with parallel systems was that the UCC and the Copyright Act had different priority systems; the UCC gives priority to the first filer, while the Copyright Act allows the recording to relate back as far as two months.<sup>15</sup>

The *Peregrine* court commented on the bankruptcy judge's underlying decision that security interests in copyrights could be perfected either in the Copyright Office or with the secretary of state under the UCC, describing the judge's analogy to holding up pants with both a belt and suspenders as "tongue-in-cheek."<sup>16</sup>

While noting that "there is no legitimate reason why pants should be held up in one particular manner," the District Court pointed out that to avoid uncertainty, confusion and error, it is important how notice of a security interest is given. Thus, the court said "a single, precisely defined recordation system" is best.<sup>17</sup>

Ultimately the court held that filing a financing statement with the secretary of state was not sufficient to perfect the security interest in the copyrights and related accounts receivable.<sup>18</sup> Only the filing of a notice of transfer with the Copyright Office was effective, as the Copyright Act preempts state law.<sup>19</sup>

The court's decision surprised the legal community. Indeed, one New York court held that it was not malpractice for an attorney to fail to file documentation of his client's security interest in copyright-related assets (the accounts and royalties for three films) with the Copyright Office, as the *Peregrine* holding was "novel and questionable with regard to intangibles relating to copyrights."<sup>20</sup>

Thus, to avoid having only "questionably" perfected its interest in copyright-related assets, a savvy secured

creditor would still need to both file a financing statement with the secretary of state's office and document the transfer with the Copyright Office.

The belt-and-suspenders approach remained among the most cautious ways to protect a creditor's interest in copyrights and their related assets, with the alternative possibly leaving the creditor open to losing its rights.

Some limits on the *Peregrine* ruling also were developed. In *Broadcast Music v. Hirsch*, for example, the 9th U.S. Circuit Court of Appeals held that an agreement to assign royalties was not a transfer of ownership under the Copyright Act and therefore was not subject to its recording rules.<sup>21</sup>

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### ***The Peregrine court said filing a financing statement with the secretary of state was not sufficient to perfect the security interest in copyrights.***

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The *Peregrine* court dealt with registered copyrights; it did not address how to perfect a security interest in an unregistered copyright. Only three days after the *Peregrine* decision, the U.S. Bankruptcy Court for the District of New Hampshire issued held in *In re C Tek Software* that there was no question that copyrights qualify as "general intangibles."<sup>22</sup> The court took for granted that a security interest in copyrights (apparently, unregistered copyrights) was properly perfected in the relevant secretary of state's office.

The U.S. Bankruptcy Appellate Panel for the 9th Circuit followed *Peregrine* by holding in *In re AEG Acquisition Corp.* that to perfect a security interest in unregistered foreign copyrights, it was necessary to register the copyrights and file notice with the Copyright Office.<sup>23</sup>

Likewise, the U.S. Bankruptcy Court for the District of Arizona held in *In re Avalon Software* that even if copyrights were not registered, there must be a filing with the Copyright Office to perfect a security interest.<sup>24</sup>

It appeared that, at least in the 9th Circuit, secured creditors could rely solely on a belt, though an unwieldy one due to the difficulty of filing such a document where no registration had occurred.

But this would not last for long. The issue of how to perfect a security interest in an unregistered copyright was finally laid to rest 12 years after *Peregrine* by the 9th Circuit in *In re World Auxiliary Power Co.*, with the panel

rejecting the holdings in both *AEG Acquisition* and *Avalon Software*.<sup>25</sup>

*World Auxiliary* concerned the copyrights in certain drawings, technical manuals, blueprints and computer software.<sup>26</sup> The copyrights were not registered with the Copyright Office.<sup>27</sup> The creditor filed financing statements with the secretary of state's office.<sup>28</sup>

The 9th Circuit noted that the Copyright Act's provisions for recording transfers of interests in copyrights are permissive, not mandatory.<sup>29</sup> Since the Copyright Office's registration system provides that searches must be by registration number or title, the panel expressed concern that no notice could be given if the copyright was unregistered.<sup>30</sup>

The court also identified a potentially serious problem for a secured creditor — it cannot register a copyright; only the owner can.<sup>31</sup>

*World Auxiliary* expressly adopted *Peregrine's* holding that the only proper place to perfect a security interest in registered copyrights is the Copyright Office.<sup>32</sup> The 9th Circuit held that federal regulation preempts state law when:

- Federal law explicitly provides that it does;
- Federal law is so pervasive that it leaves no room for state law; or
- It would be impossible to comply with both federal and state law.<sup>33</sup>

The appeals court determined that none of these elements was applicable to unregistered copyrights.<sup>34</sup> As such, it held that a secured creditor perfects an interest in an unregistered copyright by filing a financing statement with the secretary of state's office.<sup>35</sup>

*Peregrine* and *World Auxiliary* were decided under the earlier version of Article 9 of California's UCC. However, the cases still appear to be effective on these issues even though the current Article 9 does not contain the identical language deferential to federal law.<sup>36</sup>

These issues did not disappear with the *World Auxiliary* decision. Earlier this year, for example, in *In re Franchise Pictures*, a creditor obtained a lien on a debtor's personal property (including copyrights) but did not file a copy of the order, the service of which created the lien, with the Copyright Office.<sup>37</sup> The U.S. Bankruptcy Court for the Central District of California held that the creditor's lien on the copyrights was unperfected.<sup>38</sup>

## Reflections and Practical Considerations

These cases have offered some guidance to counsel seeking to advise their clients as to the perfection of a security

interest in copyrights and related assets in California. Depending on the type of asset involved, a creditor can choose to perfect its interest with the Copyright Office or the secretary of state's office. Creditors then will have a better idea where to search for other, earlier secured claims to the copyrights or other assets.

When a copyright is registered, perfecting a security interest with the Copyright Office appears to be both appropriate and relatively straightforward. This remains true even though multiple filings may be needed to comply with the federal requirement that each filing be registered by copyright number or title instead of by the debtor's name, as allowed by the UCC.

When a copyright is not registered, perfecting it with the secretary of state's office also appears to be appropriate, as copyrights are expressly included in the definition of "general intangibles" under the UCC. Fortunately, it is much easier for creditors to perfect their security interests in this manner.

Unregistered copyright assets still offer some difficulties in perfection despite the decisions made in the foregoing cases. For example, what happens if an owner registers a previously unregistered copyright without notice to the secured creditor? A prudent secured creditor should consider requiring the owner to give notice if the copyright is later registered.

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## *The belt-and-suspenders approach remains alive and well, with the alternative possibly leaving the creditor open to losing its rights.*

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What else should a secured creditor and its counsel consider doing if just entering into a security agreement for a copyright? The creditor should make sure exactly in which assets it is going to obtain a security interest (the copyright, the accounts receivable, the inventory, etc.). It should verify whether the copyright is registered and if not, and depending on the level of development of the work, should strongly consider making the registration part of the transaction.

Then, even in the 9th Circuit, the creditor should seriously consider both filing financing statement with the secretary of state and documenting the transfer with the Copyright Office. A prudent creditor may wish to take these actions since there is still some uncertainty as to the correct location to perfect security interests in copyright-related assets. This belt-and-suspenders approach still

gives the secured creditor the best opportunity to protect its interests fully.

Outside the reach of the 9th Circuit, it also seems necessary to file financing statements with the secretary of state and the Copyright Office to perfect interests in copyrights, receivables, royalties and other related assets. Unless controlling cases to the contrary are directly on point, other courts may find the 9th Circuit's reasoning persuasive. The end result is that the belt-and-suspenders approach remains alive and well.<sup>39</sup>

## Notes

<sup>1</sup> 17 U.S.C. §102.

<sup>2</sup> 17 U.S.C. § 205.

<sup>3</sup> *Id.*

<sup>4</sup> 17 U.S.C. §§ 102, 411 and 412.

<sup>5</sup> 17 U.S.C. §§ 504 and 505.

<sup>6</sup> 17 U.S.C. § 205.

<sup>7</sup> 17 U.S.C. § 408(a).

<sup>8</sup> 17 U.S.C. § 205.

<sup>9</sup> *Id.*

<sup>10</sup> *In re Peregrine Entm't*, 116 B.R. 194, 197 (C.D. Cal. 1990).

<sup>11</sup> *Id.* at 197 and 199.

<sup>12</sup> *Id.* at 200.

<sup>13</sup> *Id.* at 199.

<sup>14</sup> *Id.* at 200. Under the revised UCC, however, this argument loses its persuasive force.

<sup>15</sup> *Id.* at 201.

<sup>16</sup> *Id.* at 201.

<sup>17</sup> *Id.*

<sup>18</sup> *Id.* at 203.

<sup>19</sup> *Id.*

<sup>20</sup> *MCEG Sterling v. Phillips Nizer Benjamin Krim & Ballon*, 646 N.Y.S. 2d 778 (N.Y. Sup. Ct., N.Y. County 1996).

<sup>21</sup> *Broadcast Music v. Hirsch*, 104 F.3d 1163, 1166 (9th Cir. 1997).

<sup>22</sup> *In re C Tek Software*, 117 B.R. 762, 767 (Bankr. D.N.H. 1990).

<sup>23</sup> *In re AEG Acquisition Corp.*, 161 B.R. 50 (B.A.P. 9th Cir. 1993).

<sup>24</sup> *In re Avalon Software*, 209 B.R. 517 (Bankr. D. Ariz. 1997).

<sup>25</sup> *In re World Auxiliary Power Co.*, 303 F.3d 1120 (9th Cir. 2002).

<sup>26</sup> *Id.* at 1123.

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

<sup>29</sup> *Id.* at 1125-1126.

<sup>30</sup> *Id.* at 1126.

<sup>31</sup> *Id.* at 1126.

<sup>32</sup> *Id.* at 1128.

<sup>33</sup> *Id.* at 1128-1129.

<sup>34</sup> *Id.* at 1131.

<sup>35</sup> *Id.* at 1132.

<sup>36</sup> Section 9110(c)(1) of the California Uniform Commercial Code provides that it does not apply to the extent that a "statute, regulation or treaty of the United States preempts this division." Section 9311(a) generally provides that "the filing of a financing statement is not necessary or effective to perfect a security interest in property subject to ... (1) [a] statute, regulation or treaty of the United States whose requirements for a security interest's obtaining priority over the rights of a lien creditor with respect to the property preempt subdivision (a) of Section 9310." Section 9310 says the filing of a security interest is not necessary to perfect a security interest in property subject to a statute, regulation or treaty described in subdivision (a) of Section 9311. Section 205 of the Copyright Act seems to be sufficient to preempt California's Article 9 regarding registered copyrights.

<sup>37</sup> *In re Franchise Pictures*, 2008 WL 954162 (Bankr. C.D. Cal. 2008).

<sup>38</sup> *Id.* at \*9.

<sup>39</sup> Is there hope on the horizon? The American Law Institute and the National Conference of Commissioners on Uniform State Laws recently formed a joint review committee to identify specific provisions of Article 9 that may need revision. Perhaps they will consider clarifying which types of copyright-related assets are covered by the provision, reducing the need for some belt-and-suspenders filings. Cal. State Bar, Bus. Law Sec., Insolvency Law Committee, "Bankruptcy e-Bulletin" (June 14, 2008).

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