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## 2016 – Study Question (General)

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Security interests over intellectual property

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### I. Current law and practice

You are reminded that **IPRs** refers to patents, trademarks and registered designs only.  
If more than one type of security interest is available under your Group's current law, please answer the questions for each type of security interest, as applicable.

#### Availability of security rights

1) Does your Group's current law provide for the possibility of creating security interests over IPRs?  
yes  
Please explain:

If yes, please answer Questions 2) to 14) inclusive before proceeding to question 15) and following.  
If no, please proceed directly to question 15).

2) Are the available types of security interests defined by specific provisions relating to security interests over IPRs or by general commercial law principles (e.g. specific provisions in your Group's patent legislation rather than general commercial provisions that are applicable to tangible personal property as well as to patents)?

no  
Please explain:

There are no specific provisions in the law relating to security interests over IPRs. The specific law for registered IPRs is the Intellectual Property Act, no. 36 of 2003. This Act contains provision *inter alia* in regard to copyright and provides for the registration of industrial designs, patents and trademarks and for the enforcement of registered IPRs in Sri Lanka. The Act confers the owner of a registered IPR with three basic rights, namely to use the right, to assign the right and to conclude license contracts. It does not specifically mention the right to create a security interest over the IPR; (by way of comparison, in

the UK, section 30(2) of the Patents Act 1977, section 24(4) of the Trade Marks Act 1994 and section 19(1) of the Registered Designs Act 1949 specifically provide for the right to create a mortgage or charge over the respective IPR).

Therefore the substantive law relating to security interests over IPRs is to be found in the general principles of the law of property, which in Sri Lanka are based on the common law, as modified where relevant by statute. Sri Lanka's common law is the Roman-Dutch law. According to classical Roman-Dutch law principles, anything which can be bought or sold is susceptible of mortgage or pledge, and it does not matter whether it is movable or immovable, corporeal or incorporeal or that it is even not in existence (*Mortgage and Pledge in South Africa* by George Wille (1920), page 70). IPRs would be classified as incorporeal movables and accordingly would be capable of being mortgaged or pledged under general property law principles. The difference between a mortgage and a pledge is that in the case of a pledge the property secured is handed over to the creditor.

The common law has been amended and modified in its application by certain legislation. These are, the Registration of Documents Ordinance (Cap 117), Mortgage Act no. 6 of 1949 (Cap 89), Companies Act, no. 7 of 2007 and the Secured Transactions Act, no. 49 of 2009.

The Secured Transactions Act no. 49 of 2009 provides that certain pledges, mortgages and obligations to which the Act applies could be secured with a collateral in accordance with the provisions of the Act. "Collateral" is defined in the Act to include movable things of any nature and intangible things of any nature. Therefore IPRs would be included within this definition and could be used as security under the Act.

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[i][#\_ednref1] Section 2 of the Secured Transactions Act provides that the Act applies to:- (a) pledges, purchase agreements, conditional transfers, finance leasing agreements or mortgages of any movable property, assignment of accounts or other rights of payment of consignment; (b) agreements for sale of accounts and chattel paper; (c) lease agreements in respect of a movable property for a period exceeding one year; (d) any undertakings in terms of section 2 of the Inland Trust Receipts Act, no. 14 of 1990; and (e) any undertaking of any consignment of goods imported into Sri Lanka in terms of section 2 of the Trusts Receipts Ordinance (Chapter 86); where in each case the period of such obligation extends for a period exceeding one year.

Section 3 of the Secured Transactions Act provides that the following transactions shall be exempt from the application of the provision of this Act:- (a) the transfer of a claim for compensation of an employee; (b) the sale of accounts or chattel papers arising out of a part of a sale of a business; (c) the assignment of accounts or chattel paper instrumental for the purpose of collection only; (d) an obligation under a contract to assign the right of payment to an assignee; and (e) the transfer of an interest in goods held by the debtor as equipment or consumer goods, where the goods are registered under the Motor Traffic Act no. 8 of 2009, Sri Lanka Ports Authority Act no. 52 of 1979, the Merchant Shipping Act no. 52 of 1971, the Civil Aviation Authority Act no. 34 of 2002, respectively.

- 3) Under your Group's current law, what types of security interests are available for IPRs? In addressing the questions in sub-paragraphs a) to c) below, please specify briefly the main characteristics and differences of the available types of security interests.

- a) Does your law provide for security interests which are characterized by the full assignment of the underlying IPR to the security taker? For example, an assignment of the IPR for the purpose of security or authorization to dispose/use fully in the event of default.

yes

Please explain:

Under the common law, to constitute a pledge which shall be valid against the creditors of, or subsequent purchasers from, the pledgor, there must be delivery or what is equivalent to delivery of the subject matter of the pledge by the pledgor to the pledgee. Since an incorporeal right is not susceptible of physical delivery, the pledgor must do some act to show that he divests himself of that right and vests it in the pledgee for the purpose of the pledgee holding it as security. This is effected by means of cession of the right (Wille, *op. cit.*, p. 127, *Smith v. Farrelly's Trustee* 1904 T.S. at p. 954).

If an IPR is assigned as a security in terms of the common law, the Intellectual Property Act, no. 36 of 2003 requires the assignment to be in writing and signed by the contracting parties. The assignment may be recorded in the relevant IP register upon payment of the prescribed fee. The Act provides that no assignment shall have effect against third parties unless so recorded in the register.

It should be noted however that under the common law, the cession of an incorporeal right to a creditor to hold as security, no matter however absolute it may be in its terms, does not divest the pledgor of his *dominium* (or ownership) in the incorporeal right. Furthermore, under the common law, the mortgagee or pledgee may not sell the mortgaged property on his own (known as the right of *parate executie*), even if there is an express agreement to this effect. Similarly, an agreement to the effect that if the debt is not paid by a certain date or the mortgagor is otherwise in default, the mortgagee may hold or keep the security as his own property, (known as the *pactum commissorium*), is absolutely illegal and unenforceable under the common law. This is further elaborated in the answer to part b) of this question.

Section 17 of the Registration of Documents Ordinance (Cap 117) provides that no pledge, mortgage or bill of sale of movable property shall be of any force or effect in law or give the pledgee, mortgagee or transferee any lien, charge, claim, right, or priority to, over or in respect of such property unless (a) such property is actually delivered into the possession and custody of the pledgee, mortgagee or transferee or of some person on his behalf and continues to remain in such possession and custody until such time as the pledgee, mortgagee or transferee seeks to enforce his rights as such to, over, or in respect of such property; or (b) such pledge, mortgage or bill of sale is created by an instrument in writing signed by the person effecting the same or by some person thereto lawfully authorized by him, and unless such writing is duly registered in the office of the Registrar of Lands for the district or districts in which such property shall be at the time of such pledge, mortgage or bill of sale within a period of twenty one days.

The Companies Act no. 7 of 2007 provides that in order for a floating charge created by a company to be valid it should be created in one of the two ways in section 17 of the Registration of Documents Ordinance, subject to the modification that registration of the floating charge is in the district where the company's registered office is situated and in the register of charges maintained by the Registrar of Companies shall have effect as if the floating charge had been registered in every district in Sri Lanka. However, section 102(1) of the Companies Act requires that floating charges should be created or evidenced by an instrument that is registered with the Registrar of Companies under Part VI of the Act, which implies a written document. Therefore, it is not clear whether the method of creating a mortgage or pledge over movable property by mere delivery as provided for in section 17(a) of the Registration of Documents Ordinance would be possible. In any event, as mentioned in the previous answer, in the case of a floating charge, normally the company will continue to be able to deal with the property which is the subject matter of the charge in the normal course of business, unless the terms of the instrument creating the floating charge provide otherwise. Therefore, if a floating charge covers IPR, it would not involve the assignment of the underlying rights.

The Companies Act does not prescribe any formality for the creation of a fixed charge or security, except that in terms of section 102(1) it should be created or evidenced by an instrument that is registered with the Registrar of Companies under Part VI of the Act. Section 17 of the Registration of Documents Ordinance does not apply to the creation of a fixed charge or security.

Security interests created under the Secured Transactions Act, no. 49 of 2009 do not require the

assignment of the underlying collateral to the secured party. Section 5 of Act specifically provides that a security interest created under the Act may not be deemed to be invalid due to the rights enjoyed by the debtor to use, sell, exchange or otherwise dispose of such security.

b) Does your law provide for security interests that authorize the security taker to realize the security interest only in the event of default? For example, a pledge over an IPR that authorizes the pledgee to liquidate the pledged IPR in the event of default (but not to otherwise dispose of the IPR).

yes

Please explain:

Under the common law, the cession of an incorporeal right to a creditor to hold as security, no matter however absolute it may be in its terms, does not divest the pledgor of his *dominium* (or ownership) in the incorporeal right. The right that a mortgagee or pledgee obtains as a result of a valid mortgage or pledge is a *jus in re aliena* or real right over the property secured, to hold the property as security for his debt until his debt has been paid or satisfied, and in certain circumstances and without the consent and against the will of the pledger, the mortgagee or pledgee is entitled to have the property sold and to receive payment of his debt or claim out of the proceeds. The following are the circumstances in which a mortgagee or pledgee is entitled to have the property sold under the common law - (a) when the mortgagor or pledgor is in default of any obligation under the contract which entitles the mortgagee to foreclose, such as failing to pay the debt or the interest when it is due, (b) when the mortgagor or pledgor becomes insolvent. It should be noted that the mortgagee has to institute an action known as the *Actio Hypothecaria* for the purpose of enforcing his real right. Under the common law, the mortgagee or pledgee may not sell the mortgaged property on his own, (known as the right of *parate executie*), even if there is an express agreement to this effect. Similarly, an agreement to the effect that if the debt is not paid by a certain date or the mortgagor is otherwise in default, the mortgagee may hold or keep the security as his own property (known as the *pactum commissorium*), is absolutely illegal and unenforceable under the common law. In Sri Lanka, the action to enforce a mortgage is now subject to the provisions of the Mortgage Act (Cap 89).

Section 433(1) of the Companies Act, no. 7 of 2007 sets out the circumstances in which a floating charge shall attach to and become a fixed charge in respect of all the property comprised in the charge as follows - (a) the appointment of a receiver of the whole or any part of the property or undertaking of the company, whether under the terms of the instrument creating the floating charge or otherwise; (b) the commencement of the winding up of the company; (c) the disposal by the company of the whole or any part of its undertaking, other than in the normal course of its business; (d) the company ceasing to carry on business; and (e) any other event the occurrence of which is expressed in the instrument creating the floating charge to have the effect of causing that charge to attach to the property comprised in it. Section 433(6) of the Companies Act provides that where a floating charge has become a fixed charge under this section, the grantee may appoint a receiver under Part XV of the Act or exercise any other remedy which is available to the holder of a fixed charge under the Mortgage Act (Cap. 89) or under any other written law.

Section 439(1) of the Companies Act provides that without limiting the inherent jurisdiction of the Court under any other written law, the Court may appoint a receiver of any property which is subject to a fixed security or a floating charge granted by a company, on the application of the grantee of that security or charge, where it is satisfied that:- (a) the company has failed to pay a debt due to the grantee or has otherwise failed to meet any obligation to the grantee; (b) the company proposes to sell or otherwise dispose of the secured property in breach of the terms of any instrument creating the security or charge; or (c) it is necessary to do so to ensure the preservation of the secured property for the benefit of the grantee.

The objective of the Secured Transactions Act no. 49 of 2009 is to provide a system for recording of

security interests in movable property when used as collateral. The Act does not provide for the consequences of default by the security provider. This would accordingly have to be decided by reference to any other applicable legislation, the terms of the instrument creating the security interest, and the common law.

- c) Does your law provide for security interests that authorize the security taker to use the underlying IPR? For example, *usus fructus* rights that authorize the creditor to use and/or realize proceeds from the exercise of the IPR only during the term of encumbrance. Is any right to use the encumbered IPR conditional upon default of the security provider?

yes

Please explain:

Under the common law, if the mortgagee or pledgee is in possession of the property mortgaged or pledged to him, he is entitled to complete control over it, and the pledgor has no right to interfere with it. In the case of an incorporeal right that has been ceded to a creditor to hold as security, during the solvency of the cedent (pledgor), only the cessionary (pledgee) can enforce the right ceded. This right is accordingly not conditional upon the default of the security provider.

Accordingly, if an IPR is assigned to a creditor as a security, the creditor will have the right to use the IPR during the term of the encumbrance. If the mortgagor or pledgor wishes to use the IPR it will be necessary to enter into a separate license contract in terms of the Intellectual Property Act.

At the same time, under the common law, a mortgagee in possession has a duty to account to the mortgagor for the fruits arising from the property, either by handing them over to the mortgagor or by applying them in reduction of the debt. An agreement may however be made that the mortgagee need not account for the fruits, in which case they do not go in reduction of the debt. In the context of IPRs, if an IPR is assigned to a creditor as a security, this rule would presumably mean that any royalty income or license fees that the creditor may receive by virtue of being the assignee of the IPR have to be accounted to the debtor, or applied in reduction of the debt.

If the property remains with the mortgagor, then the mortgagor would have the right to use the property during the term of the encumbrance. Similarly, in the case of property secured by a floating charge under the Companies Act no. 7 of 2007, the company remains free to deal with the property in the ordinary course of business until the occurring of one of the events which converts the charge into a fixed charge.

Where a receiver has been appointed in respect of any property which is subject to a fixed security or a floating charge granted by a company, then subject to the instrument or the order of the Court by or under which the receiver's appointment was made, the receiver shall have and may exercise the powers specified in the Twelfth Schedule to the Act. The powers specified in the Twelfth Schedule include the power to receive the income of the property in receivership and to manage the property in receivership.

In the case of security interests created under the Secured Transactions Act no. 49 of 2009, the Act does not contain express provision authorizing the security taker to use the underlying collateral. Section 5 of Act specifically provides that a security interest created under the Act may not be deemed to be invalid due to the rights enjoyed by the debtor to **use**, (our emphasis), sell, exchange or otherwise dispose of such security. The Act does not provide for the consequences of default by the security provider.

- 4) If more than one type of security interest is available under your Group's current law, what types are commonly used for IPRs? Please also specify if certain types of security interests are exclusively used for certain types of IPRs in your country. For example, patents may commonly be encumbered with

pledges, while trademarks may commonly be assigned to the security taker.

There is no publicly available information as to what types of security interest are commonly used for IPRs and whether any types of security are more commonly used for certain types of IPR. In Sri Lanka, the preference of banks and lending institutions is to have land as a security, and IPRs remain relatively unknown as security.

#### Effects of security interests

- 5) Is the security provider restricted in their right to use their IPR after providing a security interest over that IPR? For example, in respect of their right to grant licenses, or the right to use the protected subject matter. Please answer for each available type of security interest.

no

Please explain:

The answer to question 3(c) would be applicable here as well. If the IPR has been ceded (assigned) to a creditor as a security, the creditor will have the right to use the IPR during the term of the encumbrance. If the mortgagor or pledgor wishes to use the IPR it will be necessary to enter into a separate license contract in terms of the Intellectual Property Act. If the IPR is not assigned, such as in the case of a floating charge, then subject to the terms of the agreement the security provider would have the right to use the IPR during the term of the encumbrance.

- 6) May encumbered IPRs be assigned to third parties by the security provider?

yes

Please explain:

If the IPR is assigned to a creditor as a security and the assignment is recorded in terms of the Intellectual Property Act, it would not be possible for the security provider to assign the IPR to anybody else. However, the Act provides that if the assignment is not recorded, the assignment shall not have effect against third parties.

If the IPR is not assigned as security, then in the absence of an agreement preventing the security provider from assigning the IPR, he is free to assign it to third parties. Under the Roman-Dutch common law, an agreement that the mortgagor shall not sell the mortgaged property is valid, and a sale made in breach of the agreement is void.

In the case of security interests created under the Secured Transactions Act no. 49 of 2009, the Act does not contain express provision restricting the secured property from being assigned to third parties by the security provider. Section 5 of Act specifically provides that a security interest created under the Act may not be deemed to be invalid due to the rights enjoyed by the debtor to use, **sell**, (our emphasis) exchange **or otherwise dispose of** (our emphasis) such security.

- 7) If yes:

- a) under what conditions may an IPR be assigned (e.g. obligation to obtain consent from the security taker, public notification or registration)?

If the IPR is not assigned to the security taker as security, then in the absence of an agreement preventing the security provider from assigning the IPR, he is free to assign it to third parties without having to obtain the consent of the security taker. Under the common law, if the mortgagee or pledgee

expressly or impliedly consents to the alienation of the mortgaged property by the mortgagor or pledgor, the mortgage is extinguished.

The Intellectual Property Act no. 36 of 2003 requires an assignment of registered IPR to be in writing, signed by or on behalf of the contracting parties and recorded in the relevant IP register.

If the assignment affects the information contained in an initial notice filed under the Secured Transactions Act no. 49 of 2009, the notice may be amended by filing an amendment to the notice in terms of section 15 of the Act. Section 20(2) of the Act further provides that the registration in terms of that Act shall provide the final and conclusive evidence regarding availability or non-availability of a mortgage in respect of a collateral. Therefore it is in the interest of the security taker to ensure that the notice is amended to include the assignment.

b) does the IPR remain encumbered with the original security interest for the benefit of the security taker?

yes

Please explain:

Under the common law, if there was an agreement that the mortgagor shall not sell the mortgaged property, a sale made in breach of the agreement is void. If there was no such agreement, in the case of a mortgage of movables, the principle is *mobilia non habent sequelam*, i.e. movables cannot be followed. Therefore an alienation for value of movable property subject to a mortgage or pledge will extinguish the mortgage or pledge, unless the alienee had actual, and not merely constructive, notice of the mortgage or pledge.

The Registration of Documents Ordinance (Cap 117) does not expressly provide that a mortgage of movable property registered in terms of that Ordinance shall enjoy priority over a subsequent alienation or mortgage. Therefore it is arguable that this Ordinance does not alter the common law position described above.

The Mortgage Act no. 6 of 1949 (Cap 89) contains two provisions relevant to the right of priority attaching to a mortgage of movables. Section 64 provides that where a mortgage of movable property is given (a) to secure future advances (whether with or without any previous advances or other liability) or (b) to secure the floating balance from time to time due on any account or (c) to secure any contingent liability, the movable property shall not be deemed to continue to be subject to the mortgage as against any person claiming under a subsequent mortgage or transfer, unless:- (a) such property continues, by virtue of any law other than this Act, to be subject to the mortgage to the extent of moneys actually due thereunder at the date of the subsequent transfer or mortgage, or (b) where no moneys are actually due at that date, unless such property would by virtue of such other law have continued to be subject to the mortgage if moneys had been actually due thereunder at that date.

The other provision of the Mortgage Act is section 105 which provides that where any movable property which is subject to a mortgage is seized in execution of a decree in favour of any person other than the mortgagee, the mortgagee shall be entitled to make an application to be added as a party to the proceedings and if the mortgagee is able to prove that the movable property was, at the date of the mortgagee being added as a party, subject to the mortgage and either (i) that any sum was due and payable under the mortgage at that date or on demand, or (ii) that any ascertainable sum is certain to fall due for payment under the mortgage in the future, the Court shall order that payment be made to the mortgagee out of the proceeds of the sale of the property, of the sum so proved.

Section 102(1) of Part VI of the Companies Act no. 7 of 2007 provides that where a company creates a charge to which this section applies, it shall be the duty of the company within the time specified in subsection (3), to cause a copy of the instrument by which the charge is created or evidenced, to be delivered to the Registrar for registration in terms of the Companies Act. Section 102(2)(i) specifically

provides that the section shall apply to a charge on goodwill or intellectual property within the meaning of the Intellectual Property Act no. 36 of 2003. It is also provided that the section shall apply to floating charges. Section 102(11) provides that the provisions of this section shall be in addition to and not in substitution of any other written law relating to the registration of any document or instrument creating or purporting to create a charge on any property, whether movable or immovable.

Section 103 of the Companies Act provides that subject to the provisions of this Part, every charge shall in so far as it confers any security on the company's property or undertaking, be void against the liquidator and any creditor of the company, unless it is registered in the manner and within the time prescribed by section 102 of the Companies Act or by section 91 of the Companies Act no. 17 of 1982, as the case may be, or within any extended time granted under the said Acts. Section 105(3) provides that registration of a charge under this Part shall constitute notice to all persons of the particulars of the charge entered on the register of charges under this section, but not of the contents of the instrument which creates or is evidence of the charge. Therefore, based on these provisions, a charge on a company's IPRs would need to be registered with the Registrar General of Companies in order to obtain priority over a subsequent alienation or charge.

Section 430(2) of the Companies Act provides that where (a) any property of a company is subject to a floating charge which has not attached to that property; and (b) the company has sold or disposed of that property, any person who receives that property from the company shall be liable to account to the person entitled to the benefit of the floating charge for the value of the property, in the following circumstances:- (a) if the sale or disposal of the property did not take place in the normal course of the company's business and that person knew or by reason of his relationship with the company ought to have known, that the sale or disposal did not take place in the normal course of the company's business; or (b) if the sale or disposal of the property is a breach of the instrument creating the floating charge and that person knew or by reason of his relationship with the company ought to have known, of the terms of the instrument and the circumstances giving rise to a breach of those terms.

Section 431 of the Companies Act provides for the ranking of fixed and floating charges which have been granted over the same property.

The Secured Transactions Act no. 49 of 2009 provides that its provisions shall apply in relation to the transactions covered by the Act notwithstanding anything contained in any other law. Section 20(2) of the Act provides that the registration in terms of that Act shall provide the final and conclusive evidence regarding availability or non-availability of a mortgage in respect of a collateral covered by the Act. Accordingly, although registration under this Act is not mandatory, it appears that non-registration under the Act would result in the security interest being invalid, even though it may have been registered under some other law such as the Registration of Documents Ordinance or the Companies Act.

8) What are the rights of the security taker before default (e.g. entitlement to damages, injunctions against infringers, or license fees)?

This has been answered in the answer to question 3(c).

9) Who of the security provider or the security taker is responsible for maintenance and defence of the IPR provided as collateral?

Under the common law, if the mortgagee or pledgee is in possession of the property mortgaged or pledged to him, he is entitled to complete control over it, and the pledgor has no right to interfere with it. In the case of an incorporeal right that has been ceded to a creditor to hold as security, during the solvency of the cedent (pledgor), only the cessionary (pledgee) can enforce the right ceded.



At the same time, under the common law, a mortgagee in possession has a duty to preserve the property. The degree of diligence which a mortgagee is bound to bestow on the property is the standard of a *bonus paterfamilias* (that of a prudent father of a family). Accordingly, the mortgagee would be liable to the mortgagor if the property is lost by reason of *dolus et culpa lata* (fraud or gross fraud) or *culpa levis* (ordinary negligence) on the part of the mortgagee. The mortgagee would however be entitled to be reimbursed by the mortgagor for the cost of expenses necessarily incurred by the mortgagee for the preservation of the mortgaged property. The mortgagee has a separate action against the mortgagor called the *Actio Contraria Pignoratitia* to claim such expenses, as well as the remedy of retaining the mortgaged property, even after payment of the principal debt, until the mortgagee has been repaid such amount.

Accordingly, if an IPR is assigned to a creditor as a security, under the common law the creditor will have the duty to maintain and defend the IPR. However, as stated previously, the creditor would be entitled to reimbursement from the mortgagor for the costs necessarily incurred in doing so.

If the property remains with the mortgagor, there appears to be no corresponding duty on the mortgagor to preserve the property. In this case, it would be usual to include such covenants in the parties' agreement.

10) What are the legal consequences if the underlying IPR expires or is revoked? For example, the security right lapses simultaneously; the creditor has a compensation claim against the security provider.

Under the common law, the mortgage would be extinguished if the mortgagor's title to the mortgaged property is extinguished due to some act or event beyond the control of the mortgagor. The mortgage would also be extinguished in the event of the total destruction of the mortgaged property. It follows that the security right would lapse simultaneously if the underlying IPR expires or is revoked.

Under the common law, if the property is destroyed without any fault of the mortgagee or pledgee, the mortgagee will still have his personal right of action against the mortgagor.

Section 14 of the Secured Transactions Act, No. 49 of 2009 provides that upon the expiration of the validity of a notice filed under the Act, the security interest perfected by such notice shall become invalid unless the security interest is perfected without the filing of a notice. Section 14(3) provides that if the security interest becomes invalid upon the expiration of the validity of such notice it shall be deemed never to have been perfected against a prior or subsequent purchaser of a collateral for value. A notice filed under the Act is valid for a period of five years from the date of filing, subject to it being extended by the filing of a continuation statement.

11) Can any of these effects of security interests over IPRs before default be modified by contractual provisions between the parties? If so, which effects?

yes

Please explain:

Under the common law, the parties to a contract of mortgage or pledge may add to the contract any special terms, clauses or conditions they desire, subject only to the limitation that the agreements should be honest and lawful, and that they must not have the legal effect of changing what purports to be a contract for security into a contract of another description, for example a sale or a lease. An example of a clause that would be treated as illegal under the common law would be an agreement to the effect that if the debt is not paid by a certain date or the mortgagor is otherwise in default, the mortgagee may hold or keep the security as his own property (known as the *pactum commissorium*). Similarly, the weight of authority is that an agreement that the mortgagee may sell the mortgaged property in the event of default without recourse to the courts, (known as the right of *parate executie*),

would be treated as illegal, except in the case of movable securities of small value.

Section 429(1) of the Companies Act no. 7 of 2007 provides that the terms specified in the Eleventh Schedule to the Act shall be implied terms of every instrument which creates a floating charge, except to the extent that the terms of any such instrument expressly exclude or are inconsistent with those implied terms. Section 429(2) provides that an instrument creating a floating charge may contain (a) provisions prohibiting or restricting the creation of any fixed security or any other floating charge having priority over or ranking equally with the floating charge; or (b) provisions regulating the order in which the floating charge shall rank with any other subsisting or future floating charges or fixed securities over that property or any part of it.

#### Applicable law

12) Does your Group's current law provide for conflicts of laws as to the availability and effect of security interests over IPR portfolios containing foreign as well as national IPRs?

no

Please explain:

There are no specific conflict of laws rules under Sri Lankan law as to the availability and effect of security interests over IPR portfolios containing foreign as well as national IPRs. Sri Lankan courts would usually be guided by English common law conflict of laws rules.

13) Which national law applies as to creation, perfection and effect of security interests over foreign IPRs? For example, where a US patent is provided as collateral in respect of a financial transaction in Europe.

Under the English common law, the validity and effect of a mortgage or pledge of movable property are governed by the law of the location ("*lex situs*") of the property pledged, while the relative rights of pledgor and pledgee are governed by the proper law of their transaction. The general rule is that an intangible is located where it is properly recoverable or where it can be enforced (Halsbury's Laws of England, Conflict of Laws (Volume 19 (2011)), Section 8 – Property, paragraphs 703, 706).

14) Can a choice of law provision in a security interest agreement over IPRs overrule the applicable law as to availability and effect?

yes

Please explain:

The Sri Lankan Courts would usually give effect to a choice of law provision in a contract, except if it is overridden by any mandatory national law, such as the Exchange Control Act no. 24 of 1953 (as amended). For example, section 10(1) of the Exchange Control Act provides that except with the permission of the Central Bank of Sri Lanka, no person shall in Sri Lanka issue any security or, whether in Sri Lanka or elsewhere, issue any security which is registered or to be registered in Sri Lanka, unless the following requirements are fulfilled:- (a) neither the person to whom the security is to be issued nor the person, if any, for whom he is to be a nominee is resident outside Sri Lanka, and (b) the prescribed evidence is produced to the person issuing the security as to the residence of the person to whom it is to be issued and that of the person, if any, for whom he is to be a nominee. Section 7 of the Act provides that except with the permission of the Central Bank no person shall in Sri Lanka (a) make any payment to or for the credit of a person resident outside Sri Lanka, or (b) make any payment to or for the credit of a person resident in Sri Lanka by order or on behalf of a person resident outside Sri Lanka, or (c) place or hold any sum to the credit of any person resident outside Sri Lanka; provided that where a person resident outside Sri Lanka has paid a sum in or towards the satisfaction of a debt due from

him, paragraph (c) of this section shall not prohibit the acknowledgment or recording of the payment.

Section 8 of the Exchange Control Act provides that except with the permission of the Central Bank, no person resident in Sri Lanka shall, subject to the provisions of this section, make any payment outside Sri Lanka to or for the credit of a person resident outside Sri Lanka. It is also provided by section 8 that nothing in this section is to be taken to prohibit the doing of anything otherwise lawful by any person with any foreign currency obtained by him in accordance with the provisions of Part I of the Exchange Control Act or retained by him with the consent of the bank.

#### Additional question

15) Regardless of your Group's current law relating to security interests over IPRs, is it possible to create a solely contractual regime for security interests over IPRs (i.e. beside the types of security interests defined by law) that is enforceable between the contracting parties?

yes

Please explain:

It would be possible to create a purely contractual regime for security interests over IPRs, provided however that the requirements for validity and priority to be accorded to the security interest would depend on complying with the applicable legal formalities and rules.

## **II. Policy considerations and proposals for improvements of the current law**

16) Is your Group's current law regarding security interests over IPRs sufficient to provide certainty and predictability to the parties?

no

Please explain:

It is the opinion of the Group that Sri Lanka's current law does not provide sufficient certainty and predictability to the parties regarding security interests over IPRs. There is no legal regime that specifically deals with security interests over IPRs. Instead, there are a number of overlapping legal regimes that are generally applicable to IPRs along with other forms of property, which each provide for different consequences. For example, a security interest may require registration under the Registration of Documents Ordinance, the Companies Act as well as the Secured Transactions Act, each of which entails different legal consequences in the case of registration and non-registration.

17) Under your Group's current law, is there an appropriate balance between the rights between security takers and security providers? For example:

a) are there situations in which the rights of security takers should be limited or extended (e.g. if assignment of an encumbered IPR is possible by the security provider without involvement of the security taker)?

no

Please explain:

In Sri Lanka, the main difficulty faced by security takers is the long delay involved in enforcing the security through the Court system. The delays in the Court system are an endemic problem in Sri Lanka and suggesting solutions to the law's delays would be beyond the scope of this report. To mitigate this, the legislature introduced the right of *parate* execution to banks and lending institutions, in relation to lands mortgaged as security for loans.

Apart from this, security takers should ensure that effective protections are included in the contract. Assigning the IPR to the security taker would be recommended.

- b) are there situations in which the rights of security providers should be limited or extended (e.g. if the security taker is authorized to dispose of existing licenses without involvement of the security provider)?

yes

Please explain:

If the IPR is assigned to the security taker as security, the security provider should ensure that their rights are reserved in the contract, for example an exclusive license to use the underlying IPR.

- 18) Are there any aspects of these laws that could be improved? Are there any other changes to your Group's current law that would promote transactions involving IPRs as collateral? If yes, please briefly explain.

yes

Please explain:

In view of the comments above, it is the view of this commentator that there is a clear need to provide a single and/or harmonized legal regime applicable to transactions involving IPRs as collateral. The present overlapping laws promote confusion and inconsistent legal effects.

### III. Proposals for harmonisation

- 19) Does your Group consider that harmonization of laws concerning security interests over IPRs is desirable?

no

If yes, please respond to the following questions without regard to your Group's current law.

Even if no, please address the following questions to the extent your Group considers your Group's laws could be improved.

#### Security system regarding IPRs

- 20) Should there be specific provisions regulating security interests over IPRs (i.e. separate from security interests over tangible property) generally?

yes

Please explain:

- 21) If no, should there be general commercial law principles that also apply to IPRs? If not, why?

- 22) What types of security interests should be available as minimum standard in all countries?

The Group is not in a position to comment from a comparative perspective.

- 23) Should the law be applied differently depending on the type of IPR? For example, should patents be encumbered exclusively with pledges, should trademarks be assigned to the security taker for the purpose of security?

no

Please explain:

The Group has been unable to formulate a position.

#### Effect of security interests

24) Should the security provider be restricted in their right to use their IPR after providing a security interest over that IPR (e.g. in respect of their right to grant licenses, or to use the protected subject matter)? If so, how?

no

Please explain:

This is a matter for negotiation between the parties. The Group supports the notion of “freedom of contract”.

25) Should the security provider be able to assign encumbered IPRs to third parties?

no

Please explain:

This is a matter for negotiation between the parties. The Group supports the notion of “freedom of contract”.

26) What should the rights of the security taker be before default (e.g. entitlement to damages, injunctions against infringers, or license fees)?

This is a matter for negotiation between the parties. The Group supports the notion of “freedom of contract”.

27) Should the security provider or the security taker be responsible for maintenance and defence of the IPR provided as collateral?

no

Please explain:

This is a matter for negotiation between the parties. The Group supports the notion of “freedom of contract”.

28) What should the legal consequences be if the underlying IPR expires or is revoked (e.g. the security right lapses simultaneously; creditor gains a compensation claim against security provider)?

This is a matter for negotiation between the parties. The Group supports the notion of “freedom of contract”.

29) Should it be possible to modify these effects of security interests over IPRs before default by contractual provisions?

yes

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Please explain:

This is a matter for negotiation between the parties. The Group supports the notion of “freedom of contract”.

#### Applicable law

30) Which law should apply as to the availability and the effects of security interests where a foreign IPR is provided as collateral? Why?

The Group has been unable to reach a conclusion.

31) Should a choice of law provision in a security interest agreement over IPRs overrule the applicable law? If yes, why?

no

Please explain:

The Group has been unable to reach a conclusion.

#### Additional considerations and proposals

32) To the extent not already stated above, please propose any other standards your Group considers would be appropriate to harmonize laws relating to security interests over IPRs.

The Group does not have any proposals.

33) Please comment on any additional issues concerning any aspect of security interests over IPRs you consider relevant to this Study Question.

Please indicate which industry sector views are included in part “**III. Proposals for harmonization**” of this form:

Summary