

“Negotiating the Shoals -- Financing a Licensee’s Software”

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This article reviews the limitations on a funder’s rights when financing or leasing software and provides information that a lender should be aware of when contemplating a transaction that includes license rights as collateral.

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Yes, you can get a security interest in a software license, and yes, you can lease software. You just need to understand a couple of details.

Common Misperceptions

“I paid for the license, so I must have some rights in the license”

“Once I repossess the computers, I can transfer the computers and the software as I wish”

When in Doubt, Read the Instructions

To determine what rights a lender has, you need to review the license, and review the definitions in Article 9. A lender’s rights are derivative: the lender cannot have a greater interest than the licensee. So if the license does not permit the licensee to assign the license, a lender cannot transfer or use the license either.

Under revised Article 9, a licensee’s license rights are classified as a general intangible, not a good. However, in some instances, when combined with goods, software can be treated as “goods”.

Keep this in mind as you classify the rights a lender has.

SECURITY INTERESTS UNDER ARTICLE 9

Blanket lien

Where a lender takes a security interest in all of a debtor’s assets, it needs to understand that its interest in the intellectual property may be limited.

Licenses often have restrictions or prohibitions on assignment by a licensee. A conditional assignment such as a grant of a security interest could be a default under a license. UCC 9-408 (text included below) addresses this issue by making clear that anti-assignment provisions in a license are not valid, as they relate to security interests. This means that a security interest can be created, granted and perfected without a licensor’s consent. However, a security interest does not entitle the lender to use or assign the licensee’s rights in the license,

and does not allow the lender to use the license, or enforce any rights under the license.

In the comments, example 1 of Official Comment 2 reads:

“Under this section, the term prohibiting assignment and providing for a default upon an attempted assignment is ineffective to prevent the creation, attachment, or perfection of a security interest or entitle the licensor to terminate the license agreement. However, under subsection (d), the secured party (absent the licensor’s agreement) is not entitled to enforce the license or to use, assign, or otherwise enjoy the benefits of the licensed software, and the licensor need not recognize (or pay any attention to) the secured party. Even if the secured party takes possession of the computers on the debtor’s default, the debtor would remain free to remove the software from the computer, load it on another computer, and continue to use it, if the license so permits....”

For a lender this can create a quandary if crucial or valuable software is intended to be collateral for a loan, or is needed to assure that a debtor’s operations will continue. A lender’s ability to transfer a computer may be useless without any rights in the software that runs it, and if a debtor can remove the software and use it on another machine pursuant to its license, this may impair the collateral value of the computer that secures the loan. From this provision you can see that even if the software is an expensive, valuable asset of the debtor, it may not have realizable collateral value to a lender.

In general, if the licensed software is something that is crucial to make the other collateral securing a loan operate, then any arrangements with the licensor are best made ahead of time. Many licensors will not permit transfer of the license without their consent, as they control the distribution of their products, and not lenders (who are not part of the licensor’s distribution networks). In addition, many licenses authorize use of software on more than one computer or type of computer. As a result, in many instances the monetary value of licenses as collateral is minimal, if any. To understand their rights and the limits on them, a lender needs to review the license itself.

Purchase Money Security Interest and Chattel Paper

Purchase money security interests under 9-103 (text included below) may apply to software licenses. This priority was limited to “goods” by revised Article 9, but the definition of “goods” was expanded to include the computer programs that were included in goods (such as a braking system in a car). However, if the transaction is computer programs/software only, you will not qualify for the priority, and will need to assure a first priority position by obtaining applicable lien waivers.

Chattel paper (text included below), again relates to transactions in “goods”. If the software is part of a transaction that is generally considered to be goods, you may be able to claim this, but it was not intended for a transaction comprised of significant amounts of software and one computer. For example, a software lease may not qualify as chattel paper.

LEASES

Under Article 2A Section 10103(a) (7) of California UCC: (7) **“Finance lease” means a lease** with respect to which (A) the lessor does not select, manufacture or supply the **goods**, the lessor **acquires the goods** or the right to possession and use of the goods in connection with the lease, and one of the following occurs:....”

Article 2A covers leases of goods. It is not clear whether it would cover a lease of software, especially since revised Article 9 includes licenses in the definition of general intangibles. Steve Whelan and Amy Boss, in their 1997 book on Article 2A in the series The ABCs of the UCC noted: “Although suggestions have been made that Article 2A may apply to such transfers as software licenses, recent revision efforts which propose treating software licenses in a separate Article 2B of the Code undercut such suggestions.” Article 2B is not being pursued, but recent drafts of revised Article 2 indicate that it is not intended to cover software.

In a 2004 bankruptcy case based on transaction documents executed before revised article 9’s enactment, the lessor sought to claim rights of a lessor under the Bankruptcy Code (In re CNB International, Inc. 2004 WL 635093 (Bankr. W.D.N.Y.)). The Court found that the lessor’s payment of the licensor’s invoice for the software license was not sufficient to give the lessor an interest in the license so that the lessor could lease that asset to the debtor.

The financial provisions and pricing of the payments due from the licensee made this agreement walk and talk and quack like a lease. However, several months before the “lease” was entered, the software license had granted to the licensee “a perpetual, non-exclusive license to use or permit its Affiliates to use the Product”. Because the lease did not give the licensee any additional rights to use the software (licensee already had those rights under its license), there was no lease. The court found that the lessor had acquired no interest in the license, and that “No lessor may lease that which it does not own or in which it does not enjoy at least some interest or right of possession.”

The court discussed revised Article 2A, citing California and New York case law from the 1980s indicating that licenses would be treated as goods, but because it found there was no lease, it denied the lessor’s claim. Lessor has appealed.

Unforeseen Risks to a license interest that serves as collateral

If the license is a crucial asset to a debtor licensee, a lender may want to know that even if the licensor fails, the debtor/licensee still has the right to use the

license. See Section 365(n) of the Bankruptcy Code, and review whether an escrow agreement between licensor and debtor/licensee would be beneficial, so that upon the occurrence of defined events, the source code for crucial software is released to the debtor, who can then update and/or modify the software as it needs.

OTHER REVISED ARTICLE 9 TERMS THAT CAN APPLY IN SOFTWARE TRANSACTIONS

9-102(a) Definitions and Index of Definitions.

(2) Except as used in “account for,” **“account”** means a **right to payment of a monetary obligation, whether or not earned by performance, (i) for property that has been or is to be sold, leased, licensed, assigned, or otherwise disposed of, (ii) for services rendered or to be rendered, (iii) for a policy of insurance issued or to be issued, (iv) for a secondary obligation incurred or to be incurred, (v) for energy provided or to be provided, (vi) for the use or hire of a vessel under a charter or other contract, (vii) arising out of the use of a credit or charge card or information contained on or for use with the card, or (viii) as winnings in a lottery or other game of chance operated or sponsored by a State, governmental unit of a State, or person licensed or authorized to operate the game by a State or governmental unit of a State. The term includes a health-care-insurance receivable. The term does not include (i) a right to payment evidenced by chattel paper or an instrument, (ii) a commercial tort claim, (iii) a deposit account, (iv) investment property, (v) a letter-of-credit right, or (vi) a right to payment for money or funds advanced or sold, other than a right arising out of the use of a credit or charge card or information contained on or for use with the card.**

(11) **“Chattel paper”** means a record or **records that evidence both a monetary obligation and a security interest in or a lease of specific goods or of specific goods and software used in the goods.** The term does not include a charter or other contract involving the use or hire of a vessel. If a transaction is evidenced both by a security agreement or lease and by an instrument or series of instruments, the group of records taken together constitutes chattel paper.

(42) **“General intangible”** means **any personal property**, including things in action, other than accounts, chattel paper, commercial tort claims, deposit accounts, documents, goods, instruments, investment property, letter-of-credit rights, letters of credit, money, and oil, gas, or other minerals before extraction **The term includes a payment intangible and software.**

(44) **“Goods”** means **all things that are movable** when a security interest attaches. The term includes (i) fixtures, (ii) standing timber that is to be cut and removed under a conveyance or contract for sale, (iii) the unborn young of

animals, (iv) crops grown, growing, or to be grown, even if the crops are produced on trees, vines, or bushes, and (v) manufactured homes. The term also **includes a computer program structurally integrated with goods**, any informational content included in the program, and any supporting information provided in connection with a transaction relating to the program or informational content if (i) the program is associated with the goods in such a manner that it customarily is considered part of the goods, or (ii) by becoming the owner of the goods, a person would acquire a right to use the program in connection with the goods. **The term does not include a program integrated with goods that consist solely of the medium with which the program is integrated.**

The term also does not include accounts, chattel paper, commercial tort claims, deposit accounts, documents, **general intangibles**, instruments, investment property, letter-of-credit rights, letters of credit, money, or oil, gas, or other minerals before extraction.

(75) **“Software”** means a computer program, any informational content included in the program, and any supporting information provided in connection with a transaction relating to the computer program or informational content. **The term does not include a computer program that is contained in goods unless the goods are a computer or computer peripheral.**

SECTION 9-103. PURCHASE-MONEY SECURITY INTEREST; APPLICATION OF PAYMENTS; BURDEN OF ESTABLISHING PURCHASE-MONEY SECURITY INTEREST.

(c) A **security interest in software is a purchase-money security interest** to the extent that the security interest **also secures** a purchase-money obligation incurred **with respect to goods** in which the secured party holds or held a purchase-money security interest if:

- (1) the **debtor acquired its interest in the software in an integrated transaction** in which it acquired an interest in the goods; and
- (2) the debtor acquired its interest in the software **for the principal purpose of using the software in the goods.**

SECTION 9-408. RESTRICTIONS ON ASSIGNMENT OF PROMISSORY NOTES, HEALTH-CARE-INSURANCE RECEIVABLES, AND CERTAIN GENERAL INTANGIBLES INEFFECTIVE.

(a) Except as otherwise provided in subsection (b), **a term in a promissory note or in an agreement between an account debtor and a debtor which relates to a health-care-insurance receivable or a general intangible**, including a contract, permit, license, or franchise, **which prohibits, restricts, or requires the consent of the person obligated on the promissory note or the account debtor to, the assignment or transfer of, or creation, attachment, or**

perfection of a security interest in, the promissory note, health-care-insurance receivable, or general intangible, is ineffective to the extent that the term:

(1) would impair the creation, attachment, or perfection of a security interest; or

(2) provides that the creation, attachment or perfection of the security interest may give rise to a default, breach, right of recoupment, claim, defense, termination, right of termination, or remedy under the promissory note, health-care-insurance receivable, or general intangible.

(b) Subsection (a) applies to a security interest in a payment intangible or promissory note only if the security interest arises out of a sale of the payment intangible or promissory note.

(c) **A rule of law**, including a provision in a statute or governmental rule or regulation, **which prohibits, restricts, or requires the consent** of a government, governmental body or official, person obligated on a promissory note, or **account debtor to the assignment or transfer of, or creation of a security interest in**, a promissory note, health-care-insurance receivable, or general intangible, including a contract, permit, license, or franchise between an account debtor and a debtor, **is ineffective to the extent** that the rule of law:

(1) would impair the creation, attachment, or perfection of a security interest; or

(2) provides that the creation, attachment, or perfection of the security interest may give rise to a default, breach, right of recoupment, claim, defense, termination, right of termination, or remedy under the promissory note, health-care-insurance receivable, or general intangible.

(d) **To the extent that a term in a promissory note or in an agreement between an account debtor and a debtor which relates to a health-care-insurance receivable or general intangible or a rule of law described in subsection (c) would be effective** under law other than this article but is ineffective under subsection (a) or (c), **the creation, attachment, or perfection of a security interest in the promissory note, health-care-insurance receivable, or general intangible:**

(1) is not enforceable against the person obligated on the promissory note or the account debtor;

(2) does not impose a duty or obligation on the person obligated on the promissory note or the account debtor;

(3) does not require the person obligated on the promissory note or the account debtor to recognize the security interest, pay or render performance to the secured party, or accept payment or performance from the secured party;

(4) does not entitle the secured party to use or assign the debtor's rights under the promissory note, health-care-insurance receivable, or general intangible, including any related information or materials furnished to the debtor in the transaction giving rise to the promissory note, health-care-insurance receivable, or general intangible;

(5) does not entitle the secured party to use, assign, possess, or have access to any trade secrets or confidential information of the person obligated on the promissory note or the account debtor; and

(6) does not entitle the secured party to enforce the security interest in the promissory note, health-care-insurance receivable, or general intangible.; and

(7) does not create a security interest in property of the account debtor or person obligated on the promissory note.

(e) This section prevails over any inconsistent provisions of the following statutes, rules, and regulations:

[List here any statutes, rules, and regulations containing provisions inconsistent with this section.]

Legislative Note: States that amend statutes, rules, and regulations to remove provisions inconsistent with this section need not enact subsection (e).

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