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Copyrights as Collateral: Enduser Financing for Software

Introduction

Oracle Corporation is the largest enterprise software company in the world. It operates in over 150 countries, and has made $13 billion of acquisitions in the last year, including Siebel and PeopleSoft. Oracle Financing is the vendor financing unit of Oracle (like GMAC or Ford Motor Credit, it provides alternatives to cash payments for customers that acquire Oracle products and services). Oracle Financing operates in over 40 countries.

These materials discuss enduser software financing, and while in many instances they refer to United States legal principles, the discussion highlights issues that are common around the world, due to the inconsistencies between commercial, insolvency and intellectual property laws. These laws all have different, but legitimate, objectives. Commercial law seeks to facilitate the use of capital by providing clear statements of rights, priorities and remedies. Insolvency law seeks to reorganize or liquidate a debtor in the most efficient manner to the benefit of all creditors, in accordance with their rights under commercial laws. Intellectual property law seeks to protect owners of ideas, images and processes, and allows them the right to obtain value from the distribution of those assets.

Enduser software financing illustrates the difficulties of using commercial practices to obtain financing to expand the distribution of our intellectual property products to endusers. We structure our contracts and transactions to preserve Oracle's intellectual property rights, and also to provide lenders/lessors ("funders") with a contract that has a high likelihood of repayment. If they do not get paid, funders will not continue to invest in these contracts. Since leasing and financing companies operate under commercial

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laws, and they are the ones with money to invest in these contracts, we need to make this process work, using financial products that they are familiar with for the acquisition of intellectual property rights (which are intangible assets, and have different attributes than the usual tangible assets that are financed). Providing clarity in the area of intellectual property financing will attract capital to provide funds for the acquisition of those assets, which will enable a more rapid distribution of technology.

Licensee financing where there is no transfer of intellectual property (the licensee only has a non- exclusive license to use the licensor's intellectual property)

Enduser software financing is *not* typically a collateral value play. This is because many licenses have anti-assignment clauses that restrict transfers of the license, and since a lender cannot obtain greater rights than the license conveys to the licensee/debtor, that lender could not realize value from the license by transferring it to another party if the licensee cannot transfer. Software financing *is* an "in-place value" play. How difficult is it for the licensee/debtor to replace this asset? Does that difficulty increase the likelihood of repayment? This concept should be familiar to many commercial lenders/lessors. Just like leased heating and air conditioning equipment in a building (or store fixtures in a chain store) is not a collateral value play (who would actually go in and rip it out, because the resale value is next to nothing, and is certainly less than the cost to remove it), there are instances where even tangible assets (such as laptop computers, which rapidly become technologically obsolete) have no real value at the end of a lease or financing term.

To provide enduser financing, we separate license rights and obligations from the payment terms. The payment terms are set forth in a separate contract that is assigned to a financial institution (funder). This allows the license relationship to continue without interference by a funder, and assures the funder that it has not assumed any obligations under that licensing relationship. Any claims or issues arising between the licensee and licensor will be addressed by those parties (pursuant to the terms of the license), and not through offset of payments due to the funder). By having the licensee confirm the licensor’s continued responsibility for license related claims, this structure is designed to assure: (i) that once committed under the software financing contract, the licensee will pay all sums due to the funder, without defense, counterclaim or offset, and (ii) funders are not responsible for the licensor’s obligations to the licensee (such as copyright indemnities, product warranty claims and provision of related services such as support).

Software financing contracts provide an acquisition mechanism for a licensee to acquire contract rights (not tangible goods). Those contract rights cannot be repossessed like a tangible good, so the analogous remedy is for the licensee/debtor to agree that upon a default, the funder may terminate the debtor’s right to use the financed assets. This remedy arises from the software financing contract (not the license) and is separate from and in addition to a licensor’s rights under the license. Because there are no laws providing for a separate funder’s remedy, as part of the assignment and funding process, the licensor generally will agree that it will observe the funder’s exercise of the termination remedy (so, if a license is terminated by the funder, the licensor will no longer provide support services, as there is no license to support).

Since the debtor's right to use the licensed software is subject to the terms of the license agreement, the funder's collateral is also subject to the licensor's rights. For instance, if the debtor defaults under its license, the licensor always has the right to terminate that license, thus destroying the funder's collateral (since the licensee no longer has the right to use the software). This risk of license termination is a risk inherent in a software financing transaction. As a result, in most software financing contracts, a license termination allows a funder to declare a default and accelerate payments.

Software financing contracts can be structured as installment payment agreements or as lease agreements. There are no laws that directly authorize the financing or leasing of software in order to provide, for example, the statutory insulation from debtor's product performance claims that are given to a lessor of goods under a "finance lease" in the United States under Uniform Commercial Code Article 2A. Instead, these transactions are contractual arrangements, which are structured to provide the parties with the obligations, protections and remedies that they might otherwise have if the transaction were a goods-based transaction.

Where the transaction is an installment payment agreement, a separate contract provides for installment payment terms, an unconditional promise to pay, and specific events of default and remedies.

Where the transaction is structured from the outset as a "software lease," the "asset" that is leased is the right to use the license, and the lessor is conveyed that right (either from the licensor directly or from the licensee with licensor's consent). In order to provide a lease, the lessor must acquire an asset to convey to the lessee through the lease contract (otherwise the transaction is a financing arrangement). Under the lease contract, the licensor retains all rights, remedies and obligations except the lease of the right to use the software. This protects the lessor from assuming licensor obligations such as warranty and refunds for product performance, or indemnification for infringement claims (those obligations remain with the licensor). The license is amended to provide the debtor/licensee with a limited right to use during the lease term, until all the lease payments are made. At the end of the lease term, the licensee may (depending on applicable local law) acquire the right to use, renew the lease or return the leased software.

Example of the impact of non assignment clauses in licenses: United States commercial law under Uniform Commercial Code (UCC) Section 9-408

Before UCC Article 9 was revised, it was unclear whether a security interest in a licensee's license right could be granted without triggering the default provisions of the license, which had an anti-assignment clause. In general, under UCC Article 9, assignments or transfers, or the creation, attachment or perfection of a security interest in various contract rights cannot be prohibited by terms in that contract, and cannot be an event of default under that contract. As a result, under commercial law, a grant of a security interest by a licensee will not be an event of default under a license agreement term that restricts or prohibits assignment of the licensee's license rights.

UCC Section 9-408 (Restrictions on Assignment of Promissory Notes, Health Care Insurance Receivables, and Certain General Intangibles Ineffective) provides specific provisions to override prohibitions on assignments of general intangibles (which include licenses), in the context of security interests. It does not matter what the contract says, or what the licensor intends, "…a term in an agreement between an [licensor] and a [licensee] which relates to a … license and which term restricts, or requires consent of the [licensor] to the assignment or transfer of, or creation, attachment or perfection of a security interest in the … [license], is ineffective" if it impairs the creation of the security interest or causes a default under the license.

UCC Article 9 makes clear that a security interest may be taken, but requires licensor's consent for remarketing, unless the license permits assignment. To achieve this, Official comment 2, Example 1 says "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." Therefore, even if the funder has a security interest, it generally has no right to transfer the software for value (without the licensor's consent).

These provisions attempt to preserve licensor rights to determine the distribution of its intellectual property, and also state that if the license allows it, even after computers are repossessed by a lender, a licensee can continue to use software (even if it is subject to a security interest) on a different set of computers, if the license allows that.

This provision is one of the sections where the UCC acknowledges that other bodies of law will pre-empt the provisions of this law (such as the Copyright Act). However, from a funder's perspective, while the provision allows a security interest in the debtor's license rights, it does not give the lender any rights to actually do anything with that right to recover value from the collateral. If the lender wishes to foreclose on a blanket lien and transfer assets, where a license contains a restriction on transfer, the funder will not be allowed to transfer of software (as part of a computer system or a transfer to a new entity) in mitigation of its damages upon the licensee's default, without licensor consent. In addition, the licensor's expectations (which were that its anti-assignment clause in the license would be in effect) may also not be realized, as the licensor may be dealing in some fashion with the secured lender of its licensee. This provision illustrates again that the software financing contracts are not collateral value based transactions, even where the lender takes a security interest in the licensee's rights under the license.

Insolvency issues and rights of debtors in possession/insolvency representatives to assume and transfer a license

In general, when a debtor files for protection from its creditors under bankruptcy or insolvency laws, that court has broad powers to dispose of the debtor's assets as part of a restructuring or a liquidation of the debtor. In the licensing context, that means that the court could transfer a license, even if it contains an anti-assignment clause, to a new entity. This could happen without notice to a licensor and could happen over the licensor's objection.

Typically, a licensor is not owed money at the time the insolvency filing is made by the debtor, and so the licensor is not included on the list of creditors that receive notice of the insolvency proceedings. As a result, often a licensor does not know that a license has been transferred and has had no opportunity to object or be heard in the insolvency proceedings.

A funder or insolvency court wants to quickly and efficiently restructure or liquidate the debtor, and obtain the best result for all creditors. If a licensor objects, this can slow the process, and lending and bankruptcy practitioners are concerned that a licensor may ask for treatment that may be more favorable than what other creditors receive. However, a licensor may have significant interest in who the license is transferred to. For example, a software licenser would not want the license transferred to one of its competitors, and would also not want a transfer made if that transfer would violate the export laws that apply to the licensor, which could result in severe penalties. In addition, if a licensor did not agree with the assignment of the license, once the insolvency proceeding was concluded, the licensor may be able to sue the assignee for infringement, because the assignee took the license from a party that was not authorized to transfer it, and was not in the business of distributing licenses. Without consent of the licensor, the assignee of the insolvent licensee might not be able to assure itself that it had rights in the license it acquired from the receiver or the debtor/licensee, which is not what the insolvency law seeks to provide.

A licensor has the right to control the use and distribution of its intellectual property (that is one of the characteristics of a license – that the debtor/licensee has a limited right to use, but does not own the asset). As a result, a licensor will want to preserve its right to control who uses its assets. This may not be an issue in all cases where a receiver or debtor wishes to assign the license. For example, if a licensor also has annual renewals of the support services contract for its licensed software, a transfer to an entity that will renew that support contract will not be an unattractive business proposition (unless the transfer takes a potential sale from the licensor). However, there could be a problem where a software licensor licenses its software to another company in order to have that licensee develop a program. If the developer/licensee becomes insolvent, and the insolvency receiver transfers all assets of the developer/debtor to a competitor of the licensor (or someone that is not capable of performing the development work), then the licensor would have a legitimate interest in opposing the transfer. The point is that a licensor will not generally agree to have a third party (one that the licensor did not contract with) determine who uses the licensor's asset.

Example of grant of security interest in a licensor's receivables ("proceeds of copyrighted materials") and the conflicts that can arise where there are dual

registry systems: Application of United States UCC Article 9 and United States copyright law to a lender's security interest

In those jurisdictions where there is a process for financing intellectual property pursuant to local intellectual property laws, which is in addition to the relevant commercial laws, there can be results that are not consistent, and could put funders interests at risk, which does not encourage them to provide capital in this area. For example, in the United States, the Copyright Act in some instances will pre-empt state commercial laws (the UCC), and provides for a separate registration and filing system to cover security interests in registered copyrights and the proceeds of copyrighted materials (including license fees due to the licensor). Under the Copyright Act, a security interest in a copyrighted work is considered a transfer of ownership and must be registered in the Copyright Office (17 USC Section 205).

As a practical reality, many copyrighted works are not registered at all. For software, many copyrighted software programs are also registered as patents, which provides a different set of rules for financing and filing a funder's interest. In addition, some owners of intellectual property do not register their copyrights, or only register portions of their copyrights, either because they are worried about disclosure of proprietary information, or because filing on all of their products is too burdensome.

In the United States, a security interest in a licensor's copyrightable intellectual property may require registration of the copyrights and perfection through a filing at the Copyright Office (under both the *Peregrine* and *Avalon* decisions), but an assignment of right to receive the royalties arising from copyrighted materials that have been assigned to a distributor may be subject to state commercial law (under the *BMI* and *Hayes* decisions). If a filing is required in the Copyright Office, state commercial law filings have no effect at all.

The judicial decisions that required Copyright Office registration have been strongly criticized as imposing impractical requirements (for both lenders and owners of intellectual property), and were partially overruled recently in the recent *Aerocon* decision. However, the Aerocon case, which decided whether a filing in a commercial law registry would give the lender priority in *unregistered* copyrighted materials (designs) raised another issue. If the commercial laws allow a lender to provide notice of its claim in unregistered copyrighted materials (because a filing in the Copyright Office would be rejected as the copyright has not been registered), then if those unregistered copyrights are registered, then that registration in the Copyright Office registry destroys the lender's priority under the state commercial law system, leaving them with no security interest at all. Since security interest filings in unregistered copyrighted materials would not be accepted by the Copyright Office registry, the lender who was perfected under commercial law is now unperfected under intellectual property law.

These decisions illustrate the conflict between the separate registry systems and rules in effect in both commercial and intellectual property legal systems. The money that would be treated as "receivables" of a company under commercial laws can also, when that company's products relate to registered copyrights, be treated as "proceeds of copyrighted materials" that are subject to a different body of law and registration system. A debtor can control which legal regimen would apply (by deciding to register its copyrighted materials), which provides a situation that may not be acceptable to funders and will not encourage their investment.

Potential ways to attract capital to invest in these types of transactions by making laws more consistent and predictable

Any proposals to promote consistent laws and to locally implement the Legislative Guide will need to address concerns of both funders and licensors, and as noted above, all proposals need a careful consideration of the rights of all affected parties under intellectual property, commercial and insolvency laws.

The Legislative Guide indicates that local intellectual property laws will pre-empt this commercial law. The extent of this and the areas where intellectual property law will govern needs to be set forth more clearly. Otherwise, if local courts decide these issues, then there could be significant inconsistencies, which is contrary to the intent of the Guide.

Licensors would not want their grant of a license to be characterized as a "retention of title" for which registration in a registry system would be required. This is not how they conduct business and would require significant changes in their business practices. In addition, a change of this nature would be difficult to publicize so that licensors understood how to change their practices. When a vendor of goods sells its goods, a receivable arises because title to that good has passed, but a license by its nature contemplates transfer of the right to use (and not a transfer of title). Therefore, requiring any filings by a licensor because of its "retention of title" would add a requirement on licensors that is not present in goods-based transactions.

In addition, where a vendor of goods or a lessor or other party extends credit for the acquisition of assets, if it can obtain priority in those goods over the debtor's other secured creditors by obtaining an acquisition security right (or purchase money priority), then they can claim for either payment or return of the goods. If that priority is limited to "tangible assets" or "goods," then a licensor that extends payment terms to its customer (or a lessor that enters a lease for acquisition of an intangible asset) will not have priority in that license asset. This will not reflect the commercial expectations of licensors who extend credit, and will not reflect equal treatment of all providers of acquisition financing.

Licensors will want a confirmation that they will control the distribution of their intellectual property, so the local application of default and remedy provisions would need clarification. Since the lender's rights in its collateral cannot expand on the rights a debtor has in that collateral, if the agreement governing the intellectual property right that is collateral does not permit an assignment, then a claim by a lender could not expand or ignore that limitation.

Under the Legislative Guide, upon default, a secured lender has the right to sell, *license*, or lease the collateral. Because a lender could not expand on the rights embodied in its collateral, this section would need to be clarified to add "…unless the intellectual property right does not allow assignment or transfers, in which case no transfer or use of the intellectual property right shall occur without the consent of the owner of the intellectual property." In addition, in an insolvency proceeding, a licensor will want to continue to determine who uses its intellectual property. The financial difficulties of its licensee should not cause the owner of the intellectual property to lose its right to control the distribution and use of its assets.

The lack of a validated remedy that is separate from and enforceable in addition to the licensor's enforcement rights under the license is an impediment to a lender/lessor investing its capital in the enduser financing market. In the United States, the Uniform Computer Information Transactions Act (UCITA, also called Article 2B of the Uniform Commercial Code), attempted to provide a body of law that would provide default provisions concerning licenses. While this uniform law received very limited support, it did contain provisions that validated the financing or leasing of software (something many funders found difficult to envision), and that the party providing that facility would have a separate enforcement remedy if there were a payment default.

If a licensor did not want to allow a separate remedy they could put that restriction in their license and then, because a lessor/lender's rights are derivative (they can only have rights in what their debtor can give them) then the financing would need to be done without a separate remedy, as it was not permitted by the contract right that is financed or leased. That way, if the license is one where the licensor wants to deal only with that specific licensee and does not want them to grant any other rights to any other party, the licensor can control that aspect of the relationship with its licensee.

Intellectual property rights have a great deal of value, and have specific attributes and rights that make some provisions of a secured lending law a difficult task to apply. As commercial entities acquire and use intellectual property, it is crucial to assure that any law providing financing and third party rights in intellectual property carefully consider the rights and expectations of all parties to assure that results of transactions are predictable and consistent.