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DISPATCHES FROM THE TRENCHES

A Little Something About Software Leasing and Finance

For many outside our industry, equipment leasing and finance is a niche with magical and confusing terminology and structures such as synthetic leases, operating leases, true leases, FMVø, TRACs, ALIASø and EFAs. When you add software leasing and finance into the mix, you encounter a niche within a niche. This issue of Dispatches from the Trenches briefly addresses some of the unique considerations raised by such software transactions.

Before continuing, it is worth noting that this issue of Dispatches from the Trenches is not addressing software that is embedded in existing goods in such a way that it is essentially considered to be part of the goods themselves. This type of software is generally referred to as embedded software. Most modern equipment or other personal property leased or financed today has such embedded software (for example, the computer chips in cars and other equipment). Such embedded software is generally considered part of the equipment or goods in which they are embedded and therefore does not result in the extra complexities discussed below. *See* UCC §9-102(a)(44).

Software “Leases” Generally

Leasing and finance companies should think twice before using a standard lease document when a major component or costs of the leased equipment constitutes software. In fact, the statutory framework of the Uniform Commercial Code does not allow for a lease of software.

Under UCC §2A-103(1)(j), the term lease is defined to mean a transfer of the right to possession and use of goods for a term in return for consideration. Article 2A defines goods as: all things that are movable at the time of identification to the lease contract, or are fixtures (Section 7-2A-309), but the term does not include money, documents, instruments, accounts, chattel paper, general intangibles, or minerals or the like, including oil and gas, before extraction. The term also includes the unborn young of animals.

General intangibles is the catch all category of personal property under the Uniform Commercial Code and the definition expressly includes software. More specifically, general intangibles are defined as 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 payment intangibles and software. UCC §9-102(a)(42)(emphasis added); *See also* UCC §2A-103(2).

The fact that software "leases" are not a concept recognized by the Uniform Commercial Code means that lessors do not receive the statutory hell or high water clause or other provisions carefully crafted into Article 2A of the UCC to protect lessors who are primarily a money source (as opposed to a vendor of the leased items). Although lessors can try to contractually protect themselves with strong lease documents that simulate the same statutory concepts, it is always better to have the extra protection of the Uniform Commercial Code and case law interpreting it

Of course, those involved in drafting the UCC put a great deal of thought and effort into their work. The idea that software cannot be leased makes sense in some respects. The idea behind a lease is that the lessor owns the leased property and grants the lessee the right to use it. When it comes to software, however, neither the lessee nor the lessor own the software. Rather, the licensor (who may not necessarily be the vendor dealing with the lessee or lessor) owns the intellectual property which constitutes the software.

Rather than selling the software, the licensor or its designee provides a copy of the software to the would-be "purchaser" and sells a license constituting the right to use that copy. There are many variations on the theme. Licenses can be exclusive or non-exclusive, limited or unlimited and perpetual or subscription, just to name a few differences. These distinctions are beyond the scope of this edition of Dispatches from the Trenches. The main points are that: (1) software is dramatically different from the type of tangible personal property traditionally involved in equipment leasing and finance; and (2) software licenses often carefully limit the manner in which the software can be used and often, for example, prevent the purchaser of the license from assigning its right to use it to third parties except in limited circumstances. Consider the affect of such a restriction on lease provisions requiring the lessee to "return" the software to the lessor at the end of the term unless purchased in accordance with the terms of the lease. As noted below, such restrictions also devalue the software as a form of "collateral" for the lessee's obligations.

Realizing Value from the Software Upon Default

Even if the leasing and finance company uses a software finance agreement or similar documentation to make clear that it is *financing* its customer's acquisition of the software license, the lender's security interest in the software can be of questionable value. As such, many leasing and finance companies approve (or disapprove) the their customer's credit on an unsecured basis. The risk stems from the fact many license agreements contain language which, in one form or another, forbids the licensee (i.e. the lessee or borrower) from assigning or otherwise pledging its rights under the license agreement. These provisions are commonly referred to as "anti-assignment provisions."

Although such provisions do not technically prevent a lender from obtaining a security interest in a software license, the Uniform Commercial Code makes clear that the owner of the license does not have to recognize the security interest or otherwise cooperate with the lender in any way. In particular, Section 9-408 of the UCC provides that a lender's security interest in such software: (1) is not enforceable against the person obligated on the [license]; (2) does not impose a duty or obligation on the person obligated on the [license]; (3) does not require the person obligated on the [license] to recognize the security interest, pay or render performance to the [lender], or accept payment or performance from the [lender]; (4) does not entitle the [lender] to use or assign the [borrower's] rights under the on the [license]; (5) does not entitle the [lender] party to use, assign, possess, or have access to any trade secrets or confidential information of the person obligated on the [license]; and (6) does not entitle the [lender] to enforce the security interest in the on the [license].

As such, the lender has no assurance that it will receive any value from its security interest. Of course, having the licensor's consent prior to entering into the software financing could address this issue but a large portion of licensors are unwilling to execute such agreements.

Other Complexities

There are other complexities that need to be considered from a credit approval, documentation and procedural standpoint when financing software. For example, customers financing software or other technology equipment often have a much stronger need to be able to modify and upgrade it. Due to the potential problems of realizing value from software, experienced leasing and finance companies should be able to provide more flexibility to customers with strong credit.

Another issue relates to the confidential and proprietary information that can often be stored in, or otherwise discoverable from, software. When it comes to the lessee's or borrower's information, a leasing and finance company can generally protect itself through contractual waivers within its form documents. However, consider the risks lurking if the confidential or proprietary information belongs to customers of the lessee or borrower. Care should be taken not to violate the rights of such persons or applicable law protecting those rights, such as the Health Insurance Portability and Accountability Act (HIPAA).

The foregoing list is not exhaustive in any respect and the message is simple—software leasing and finance is a niche within a niche and leasing and finance companies new to that area should proceed cautiously.

Kenneth P. Weinberg is a founding partner of Marks & Weinberg, PC. He and co-founder, Barry Marks, have significant experience in dealing with virtually every type of equipment and facility lease financing, have participated in leasing financings for more than a billion dollars of equipment and are recognized throughout the industry. Weinberg has written *Dispatches from the Trenches* since 2002, routinely writes articles in a variety of equipment leasing and financing journals, and has participated in numerous seminars on equipment leasing issues. If you would like more cases or articles on leasing, or have any questions or comments about this column or other leasing issues, please visit www.lease lawyer.com or contact Weinberg at 205-251-8307.



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