

# **SOFTWARE LEASING AND FINANCING**



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# Software Financing: Identifying and Reducing Legal Risk



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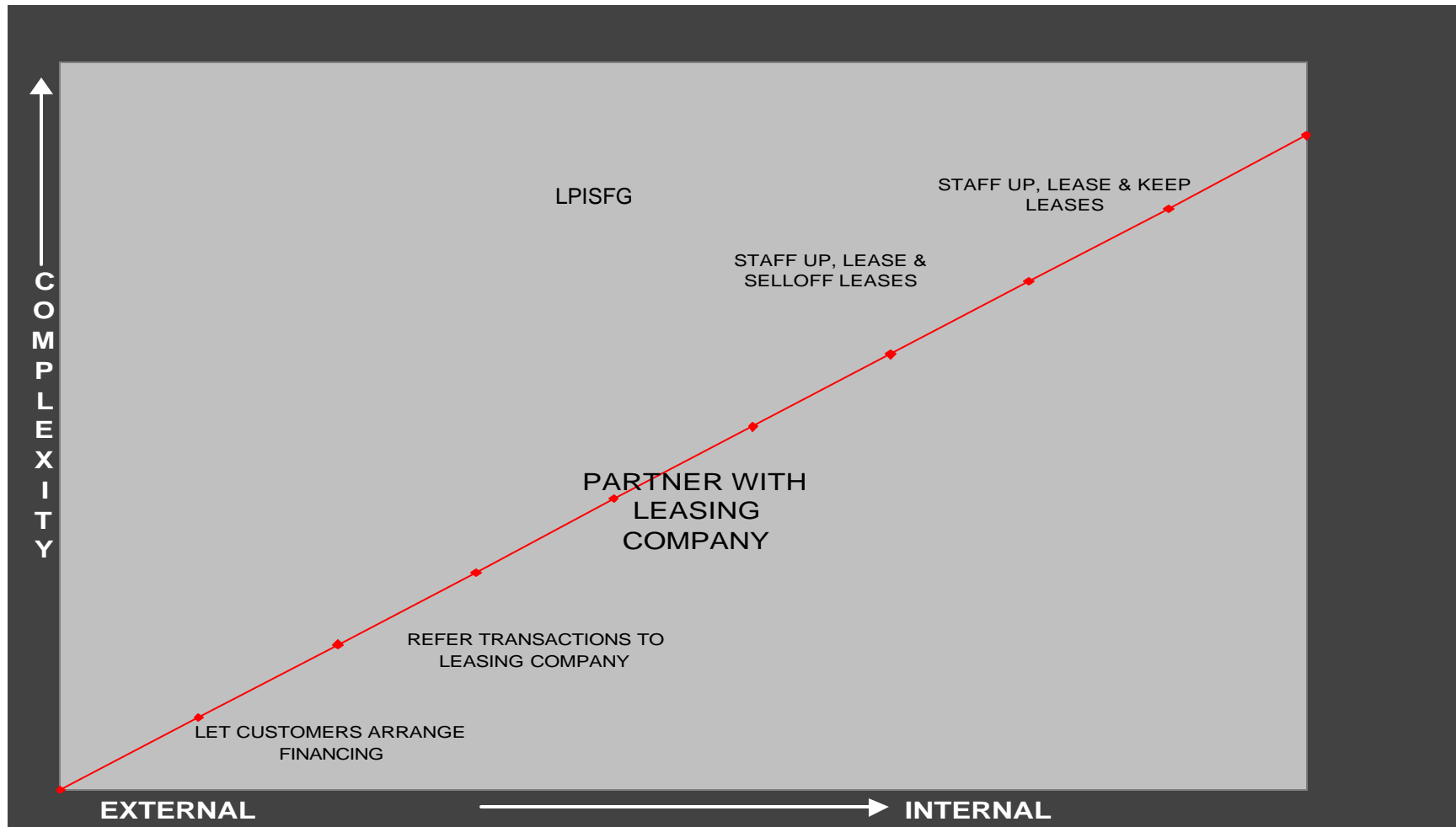


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# You Need to Understand

- ❖ Software Industry (Very Different From Hardware)
- ❖ Software Industry Accounting Practices
- ❖ Software Licensing Practices
- ❖ Intellectual Property Law
- ❖ Collateral Value of Software Vs. Lessee Credit
- ❖ Liens on Software Licenses
  - ❖ New UCC 2B & Revised UCC 9
- ❖ Leasing Through Software Company or Directly
- ❖ Investment Grade Vs. Middle Market Segments
- ❖ How to Get Your Lenders To Finance Software !!

# How Software Companies Use Leasing



# Future Sea Changes Affecting Software Industry



Year 2000 Issue  
Network Computer  
Total Cost of Ownership  
Sub \$500 PC  
High Bandwidth Internet  
Connectivity

Massively Parallel Processing  
Convergence  
Component Technology  
Speech Recognition  
Human Computer Interface  
Windows NT Vs. UNIX

# Software Company Profiles



- ❖ Number of Companies  
25,000 - 30,000
- ❖ Company Size  
85% Have Revenues Less Than \$25 Million  
68% Have Less Than 50 Employees
- ❖ Company Ownership  
78% Are Private
- ❖ Company Location  
Across U.S., But Some Concentrations

# Transaction Structure



- ❖ Lease Vs. Installment Purchase Agreement!
- ❖ Check License Provisions
  - ❖ Any Prohibitions on Leasing Company Lien?
  - ❖ Nontransferable?
  - ❖ Exclusive?
  - ❖ Perpetual?
  - ❖ Anything Else Strange?



# Transaction Structure



- ❖ Secured Vs. Unsecured Financing
  - Do You Want A Security Interest?
  - Can You Get A Security Interest?
  - Will Software Company Allow It?
- ❖ To Obtain a Security Interest in License
  - File UCC-1 If Non-Exclusive License
  - Copyright Office Filing if Custom Software
- ❖ Remarketing Rights
  - Do You Need Them?
  - Will Software Company Grant Them?

# Transaction Structure



- ❖ Vendor Remarketing Assistance
  - Accounting Problems
  - Forget It
- ❖ Financing Services
  - Separate From The License?
  - Collateral Value
  - Security Interest
- ❖ Lessor Rights Upon Lessee Default
  - Do You Need Software Company Assist?
  - Will Software Company Assist?

# Software Financing Issues:



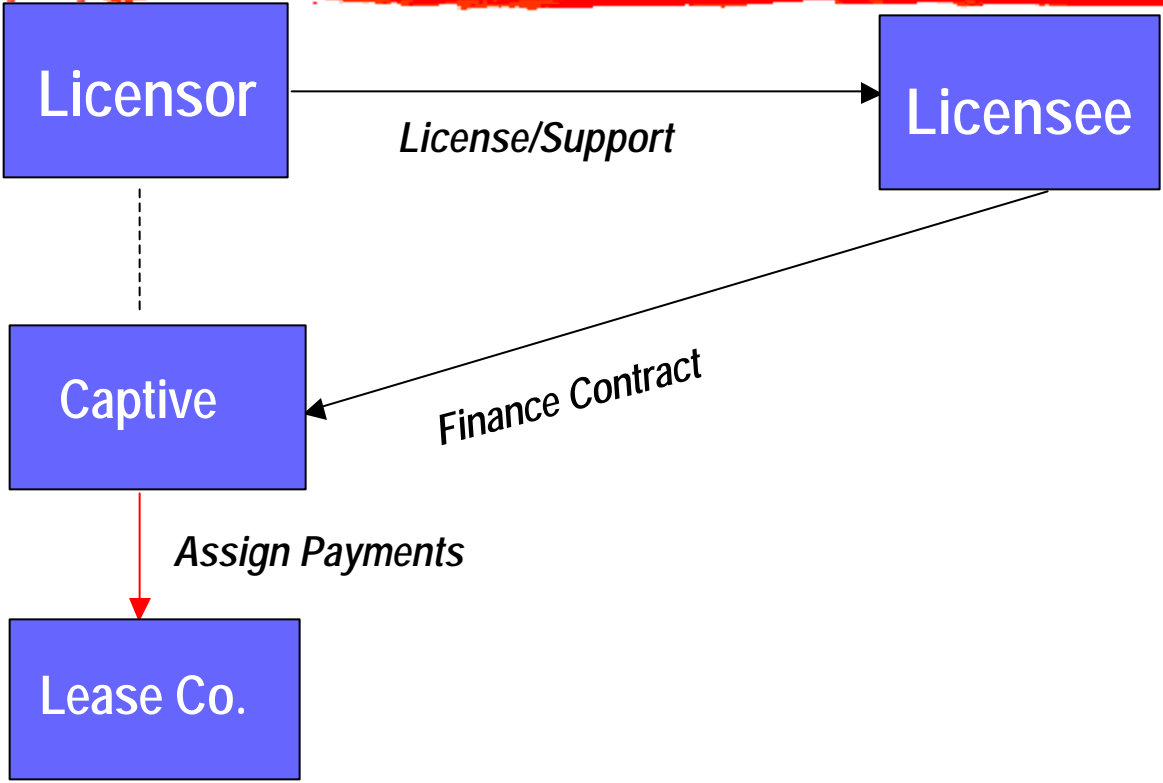
## Update on Legal Developments

# Overview



- ❖ Software vendor programs (licensor financing)
  - ❖ Performance risk of licensor
  - ❖ Assignability
  - ❖ Perfection issues
- ❖ Direct software leasing (licensee financing)
  - ❖ Perfection issues
  - ❖ Remedies and remarketing
  - ❖ Bankruptcy issues
- ❖ Other common software financing structures
- ❖ Draft UCC Article 2B

# Software Vendor Program



# Performance Risk of the Licensor



- ❖ **Problem: if the licensor does not perform, will the licensee still be obligated to pay?**
- ❖ **Solution:**
  - ❖ **Review the license and assess the risk**
  - ❖ **Specify which payments are for license fees and which are for services**
  - ❖ **Include hell or high water language**
  - ❖ **Consider a separate payment instrument**
  - ❖ **Recommend a captive finance subsidiary**
  - ❖ **Limited recourse to the licensor**

# Assignability of the License and Payments



- ❖ **Problem: license may prohibit licensor from assigning payments or granting security interests**
  - ❖ **Solution: get licensee consent (UCC 9-318(4) does not apply to a sale)**
- ❖ **Problem: license may be assignable by the licensee (i.e. credit issue)**
  - ❖ **Solution: have original licensee acknowledge that it will continue to be obligated to pay**

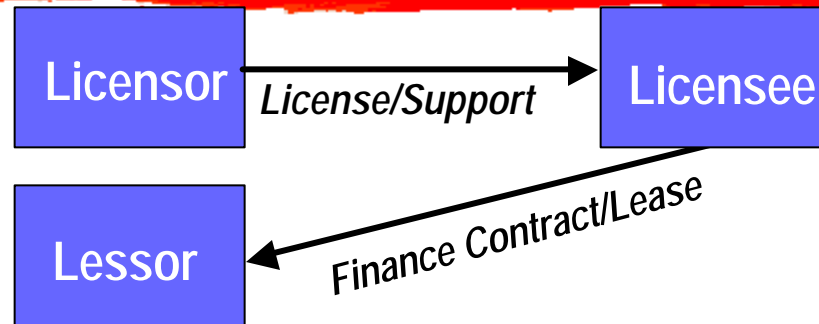
# Perfection Issues in a Software Vendor Program



- ❖ **Problem: to perfect in software or software receivables, lease co. must file in the US Copyright Office; UCC-1 is ineffective**
- ❖ **Solution:**
  - ❖ **Accept the risk for investment-grade portfolios**
  - ❖ **Require Copyright Office filings for high risk portfolios**
  - ❖ **Recommend using a captive finance subsidiary**




# Software Lease - Licensee Financing



- ❖ Technically, not a “lease” under the UCC
- ❖ Not “chattel paper” (to extent there is software)
- ❖ No purchase money priority in software
- ❖ Probably a “lease that creates a security interest”
- ❖ Lessor can terminate the Licensee’s right to use the information licensed

# Perfection Issues in a Third-Party Software Lease



- ❖ **Problem: how do you perfect a security interest in a nonexclusive license?**
  - ❖ **Solution: file a UCC-1; consider filing federally**
- ❖ **Problem: even if you do perfect, what rights do you have?**
  - ❖ **Solution:**
    - ❖ **As a matter of federal law, licensor consent is required to transfer the license**
    - ❖ **There may still be some benefit to having the status of a secured creditor (e.g. right to proceeds)**

# Acceptance



- ❖ **Problem: software licenses often do not have an acceptance provision**
- ❖ **Solution:**
  - ❖ **Have the licensee acknowledge acceptance of the software**
  - ❖ **In a vendor program, have the licensor represent and warrant that the software has been accepted**

# Remedies



- ❖ What remedies does lessor have with respect to the software?
  - ❖ Right to terminate the licensee's right to use the information licensed
  - ❖ Right to terminate support
  - ❖ Right to repossess disks and manuals
    - ❖ Watch out for liability to the licensor!
- ❖ Software itself usually has no residual value

# When Can a Leasing Company Remarket Software?

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- ❖ **With consent of the licensor**
  - ❖ **Limited remarketing rights are often granted in connection with the financing of an integrated system of equipment and software or a software vendor program**
- ❖ **When there has been a “first sale” of a copy of the software**
- ❖ **When the software is transferable by its express terms**
- ❖ **When the license is a mass market license?**

# Bankruptcy of the Licensor



- ❖ The license would be an executory contract that could be rejected by the licensor
- ❖ Section 365(n) of the Bankruptcy Code allows the licensee to continue using the licensed software, so long as it continues to pay
- ❖ Consider using a payment instrument separate from the license
- ❖ Consider a bankruptcy remote, securitization structure

# Bankruptcy of the Licensee



- ❖ Does lease company have a first priority claim to any proceeds of the software license?

# Other Common Software Financing Structures



- ❖ Systems integration (bundling of equipment, software, and services)
- ❖ Securitization of software receivables
- ❖ Term licenses (similar to an operating lease)



# Scope of Article 2B of the Uniform Commercial Code



- ❖ Article 2B applies to “licenses” and “software contracts”
- ❖ Article 2B also covers agreements to provide support for, maintain or modify software
- ❖ The current draft includes provisions regarding the financing of software

# Status of Article 2B of the Uniform Commercial Code



- ❖ Revised Article 2B will be presented to the American Law Institute (ALI) Council in October, 1998
- ❖ If approved, NCCUSL will probably proceed with the adoption stage
- ❖ ALI members would consider final approval in May, 1999
- ❖ The changes could be passed into law as early as January 1, 2000

# Current Gap in the UCC



- ❖ Article 2A of the UCC covers only leases of goods
- ❖ Article 9 on secured transactions does not cover issues relating to the underlying license
- ❖ As a result, there is currently a gap in the coverage of the UCC
- ❖ Article 2B will help to fill the gap

# Hell or High Water Clauses



- ❖ Article 2B recognizes that software may be financed using a debt or a lease (license/sublicense) structure
  - ❖ Article 2B does create a safe harbor for transactions where the leasing company licenses software from the software company and sublicenses it to the end-user (2B-619(b))
- ❖ If included in the financial accommodation contract, a HOHW clause will be enforceable (2B-619(d))

# Purchase Money Status



- ❖ There is no purchase money status for software under Article 2B or existing Article 9
  - ❖ If you have a lease that creates a security interest, watch out for prior liens!
- ❖ New draft Article 9 will allow purchase money status for software acquired for use in goods