Puncturing the 15 Myths of Software Leasing

By Mark S. Bazrod

A 100% software lease as a separate leasing product offered by independent lessors has been available for at least 20 years.[1] The provisions of most software leases are similar to equipment leases, but they require some additional provisions due to the uniqueness of software.

One would think that by now most lessors, software vendors, and users would be aware of software leasing, understand it, appreciate its utility, and be familiar with its structures. Not so! Many lessors are averse to leasing software; numerous software vendors are still surprised software is leaseable; and at a recent Webcast, more than one-third of the user attendees (mostly from large corporations) indicated that they did not know software can be leased.

Why? Perhaps because a number of myths have arisen regarding software leasing. Most are in fact misconceptions, stated or unstated, that have arisen because of unfamiliarity with intellectual property (IP) concepts, the perplexing terminology of software licenses, the novelty of leasing intangible property, the lack of guidance in the Uniform Commercial Code (UCC) prior to its recent revision, the confusion between the intellectual property in the software and the software license, the failure to recognize that software is more valuable than hardware, and the software industry's lack of knowledge about leasing.

So the purpose of this article is to unmask these myths – or at least the myths that software leasing specialists continue to encounter. Unfortunately, the discussion of myth 2 is somewhat legalistic, but have patience: the rest of this article is written primarily from a business standpoint.

But first, what is software leasing and what do software leasing transactions look like? In general, software leasing is the financing (not the leasing, despite the form of document) of a perpetual, nonexclusive, nontransferable software license (not the developer's rights in the software) under a capital lease, where the lessee makes no payment at lease termination and the lessor's rights expire. The transaction can be documented as a lease, an installment payment agreement, a promissory note, or a rider to a license.

However documented, software leasing is a financing and not a true lease.[2] Historically, the product has been called “software leasing” and not “software financing,” so there is no use in arguing over the semantics. After all, capital leases with $1 purchase options are still termed leases, but they are governed by secured financing law under UCC Article 9.

So let's take a look at 15 myths about software leasing.

Myth 1. The Software License Is the Same as the Intellectual Property in the Software.

People often confuse the software license and the intellectual property in the software. A license is the grant to a user of the right to use a particular piece of software, such as Microsoft Word. The intellectual property is much more encompassing. It is all the developer's rights in the software and is similar to the rights derived from ownership of equipment. These rights include the right to sell, transfer, or assign the intellectual property to others; license others to use the software; restrict others from using the software; and use the software as security for a loan. Thus, Microsoft owns the intellectual property rights in Word; the users own only a license to use Word.

Myth 2. Software Leasing Is Unsecured Financing – A Lessor Cannot Get a Security Interest in Software.

Initially, the argument that a lessor cannot obtain a security interest in software was the largest obstacle to software financing. Until 2001, Article 9 of the Uniform Commercial Code (Old UCC) did not even mention software. One had to assume that software and software licenses were included in "general intangibles," in which a

A number of myths and misconceptions surround software leasing. There are many reasons that is so. However, from a credit and collateral standpoint, software leasing is superior to most other types of equipment leasing. This article sheds light on how to decide whether software leasing makes sense from a business standpoint.

The developer's rights in the software can be registered with the U.S. Copyright Office, but they do not have to be. In fact, copyright protection attaches the moment the work attains tangible form – without any registration.

lessor could get a security interest under Old UCC 9-106. It seemed pretty self-evident to some, but a number of attorneys disagreed, at least in the early and mid-1990s.

Article 9 applies to any transaction that creates a security interest in personal property.[3] General intangibles are a form of personal property.[4] Revised Article 9 of the UCC, which became effective July 1, 2001, specifically provided for the first time that the term general intangible includes software[5] and very briefly defined the term "software" – a computer program – but at least there was a definition and an inclusive reference.[6] Thus, for the first time it has become clear (almost) that one can obtain a security interest in software. Software that is "embedded" in goods becomes part of the goods.[7,8]

However, there was (and to some extent still is) the thought that software is copyrightable and therefore a lessor could not obtain a UCC security interest in the software intellectual property or the license, given that federal law regarding registration of copyrights preempts obtaining a security interest in the software under the UCC. The language of the Old UCC seemed to some to indicate that state filing was preempted because the Copyright Act does have a system for recording liens, although it is cumbersome and ineffective in a number of ways.[8]

The Revised UCC Sections 9-109(c)(1) (and Comment 8) and 9-311 (and Comment 2) provide that the UCC does not apply if federal law preempts Article 9. In the landmark *Peregrine* case,[9] the District Court held that for *registered* copyrights the Copyright Act preempted the UCC, a filing with the Copyright Office was required, and a filing under the UCC was ineffective. In the *Aerocon* case, the 9th Circuit Court of Appeals held in a well-reasoned opinion that for unregistered copyrights, there was no preemption, there was no way to file a security interest in unregistered software under the federal system, and a state filing under the UCC was effective.[10]

Nonetheless, these cases apply to the copyright intellectual property and not licenses of such property. This distinction is critical and obvious to IP practitioners, but not so to the rest of us. So what about licenses (software or otherwise)? A search of the decided cases did not find any relating to license situation, so reason and logic must dictate the answer at this point.

The developer's rights in the software can be registered with the U.S. Copyright Office, but they do not have to be.[11] In fact, copyright protection attaches the moment the work attains tangible form – without any registration. Registration brings certain benefits but also certain disadvantages. For example, registration requires disclosure of some of the software code. The developer may want to limit disclosure of the software code, which can be protected by other means, including trade secret protection.

Section 205 of the Copyright Act of 1976 provides that "any transfer of ownership" may be recorded in the Copyright Office, and Section 101 defines a "transfer of ownership" as "an assignment, mortgage, exclusive license … or any other hypothecation …, *but not including a nonexclusive license*" [emphasis added].[12] Thus, even if the software intellectual property is registered with the Copyright Office, there is no way for a nonexclusive license of the software to be recorded and no way for an assignment of or security interest in a nonexclusive license to be recorded. *A filing under the UCC is the only way, both legally and mechanically, to obtain a security interest in a nonexclusive license of registered or nonregistered software, similar to a security interest in an unregistered copyright.*

Of course, there is still a theoretical question as to the validity of the security interest, because there are no court decisions that squarely rule that a security interest in a nonexclusive software license can be perfected through a UCC filing. However, the well-reasoned *Aerocon* decision by a unanimous and respected 9th Circuit Court should satisfy all but the most conservative attorneys.

Thus, a lessor can be very confident that a UCC filing is effective for nonexclusive licenses – and most software licenses are nonexclusive licenses. There is no way to obtain a "federal security interest," federal preemption doesn't apply, and one obtains a normal security interest under the appropriate state law. In the few instances of exclusive software licenses, a lessor will need to have the software intellectual property registered with the Copyright Office and then have the exclusive license and its security interest recorded with the office.

Myth 3. Software Financing Is Unsecured Financing – Software Licenses Cannot Be Resold.

Some people claim that a security interest in software is not worth anything since software licenses are almost always nontransferable and cannot be sold in the event of a default. So even if they accept that a lessor can obtain a security interest in software, they argue that software leasing is effectively unsecured financing.

What they overlook is that software is an indispensable asset that the user needs to operate its business: word processing, spreadsheets, financial statements, customer relationship management, inventory control, manufacturing planning, and so on. Thus, when financial difficulties arise, software lease payments tend to be made because of the indispensable nature of the software. Although a lessor generally cannot repossess software and legally transfer the license to another, a software lease should preclude the user from using the software in the event of default. Industry experience has been that the lessor tends to recover the monies due unless the user is liquidated.

The essence of a security interest is the right of the lessor to enforce the obligations of the lessee through a preferred claim on a specific asset. Thus, the probability that the lessee will continue making payments because of the importance of the collateral to the continuation of the operation of the business means that a security interest in such collateral has very high value.

A security interest in a machine tool or most business software results in a much higher probability of continued payment than a security interest in incidental equipment or software. How many manufacturers can operate without their CAD/CAM systems? How many businesses can run without their accounting and financial systems? Without their websites? Without their word processing systems?

The other elements that add value to a security interest are the extent to which a lessor can obtain physical possession of the collateral and, once possession is obtained, the value that the lender can obtain from the sale of the equipment. The right as a secured creditor to prevent the use (most important in software leasing) of an often strategic asset provides a lessor with an important bargaining advantage in negotiations with both the lessee and other creditors. Normally this right as a secured creditor precludes the need to try to repossess an asset and resell it.

Can the lessee retain a copy of the software and use it in violation of the lease? Certainly. However, a good relationship with the vendor should result in the lessor learning of this violation. There are other ways as well to ascertain if there has been a violation, but that goes beyond the scope of the article.

Myth 4. Software Development Is Rapid, so Software Must Depreciate Quickly, and Users Will Use Software Only for a Short Period.

The software industry is not monolithic. Without getting into too many details, we can acknowledge that the different segments develop at different rates. New business models, such as Web-based applications, open-source software, subscription pricing, and pay-for-use pricing continue to evolve. But that does not mean users adopt new software and models quickly. Many users use older versions for years.

The use of older versions of Microsoft Windows operating systems is a case in point. Conversion costs, cost of integration with other applications, cost of retraining personnel, and the need for additional IT resources are often high. Business spent billions on revising older software

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applications to solve the Year 2000 problem rather than acquire newer software applications.

Moreover, the arguments for rapid depreciation ignore one of the most salient aspects of the software business model: most users obtain a maintenance and support contract with the vendor so that they are entitled to new releases of the software without further payment. Thus, three years after software acquisition the user has the latest version of the software, making the argument of rapid change in the software industry often academic and irrelevant. So software generally does not become obsolete like hardware. A lessee generally cannot obtain a cheaper up-to-date version, and making lease payments is cheaper than obtaining a replacement – without even considering conversion costs.

Myth 5. Software Has No Value in Bankruptcy.

In the early 1990s, some software lessors often had the right to remarket software, and many vendors agreed to use their best efforts to remarket the software. However, except for some Microsoft products, most software vendors now do not permit a license to be transferred – that is, remarketed. Therefore, the critical question is not whether the lessor can remarket the software; it is whether remarketing is critical or even necessary. In most cases a lessor will not need to consider the remarketing question because the lessee will either pay (after threatening to stop it from using the software) or go into bankruptcy.

The problem has been that until recently it was not possible to categorically prove that proposition that remarketing is not critical. Software has been leased for a relatively short time, and most leases have been with better credits so that the potential for default has not been great. There are, however, at least five cases in bankruptcy involving software financed by a well-known leasing company. All the cases involved transactions where the lessor did *not* have a security interest in the license! All assumed that the software was necessary to run the business and there were no disputes as to the value of the software. All really involved the issue as to whether the right to terminate use was the equivalent of a security interest.

In several of these cases, the attorneys for the unsecured never raised the issue (out of ignorance), and in one there was a 100% payout to creditors so the issue was moot. However, in one case the unsecured creditors claimed the lessor was unsecured. The lessor did not contest the claim, recognizing that without a filing it was in fact unsecured. Somewhat parenthetically, the lease structure with a security interest in the software license was designed to preclude this dilemma.

In the last several years our company has seen two of its public software lessees go into bankruptcy. Our claims as a secured creditor were recognized in both cases. In one, the trustee bought out the lease, and in the second, prepetition delinquencies (arrearages) were paid and we were one out of only four creditors to be paid on a current basis. Consequently, there is validation that not only are a secured interest in software recognized and default provisions legally enforceable, but that the economic value of the software results in payment of the lessee's obligations.

The cases, absent a decision on point, should go a long way to giving a lessor comfort that software has substantial in-place value and that a well-structured software transaction should prevail in a Chapter 11 proceeding, thereby protecting the lessor against loss.

Of course, there is still a theoretical question as to the validity and value of the security interest. There is no court decision that squarely rules that not only is a UCC-perfected security interest in a nonexclusive software license valid but also that the value of the software (the maximum value of the secured party's claim) is the in-place value of the software.

Nonetheless, in *Associates Capital Corp. v. Rash*,[13] the U.S. Supreme Court held that the definition of market value should be based on the disposition of the equipment. In other words, if the equipment were to be sold, the market value would be the resale value, whereas if the equipment were to be retained by the bankrupt, the market value would be the in-place value to the bankrupt.

Applying this concept to software financing, the conclusion would be that in a Chapter 7 liquidation proceeding, the value would be zero if the license is nontransferable and has no resale value, whereas in a Chapter 11 reorganization proceeding, the value would be the in-place value. In most instances this value would be more than the original cost and thus more than the secured party's unrecovered investment and claim.

Myth 6. A Lessor Should Lease Only "Essential" Software.

That a lessor should lease only "essential" software is one of the biggest myths of all about software leasing, perhaps because it seems so logical. However, almost all software is an indispensable asset that the user needs to operate its business. So lessors should recognize that almost all software is essential and therefore leaseable. Years ago some lessors did not lease website software because if the site wasn't successful, the lessee might stop paying and the threat to prevent the use of the software wasn't creditable. Today almost every business needs a website so now most websites are leaseable. (See myth 4, above.)

Myth 7. A Lessor Should Not Finance Services.

Some companies will finance only the license, not customization, installation, or other services. Why? They say the services have no resale value. But nor do most software licenses if they are nontransferable. If you believe that the software is indispensable to business operation, the same logic applies to the services. Of course, you don't want to pay for services that have not been performed (see the Norvergence cases[14]); you pay for services as performed by some agreed-upon measure.

In addition, knowledgeable users don't want the lessor paying for unperformed services. Thus lessors should obtain their approval before payment and they will be protected. One caveat: if services are to be performed over an extended period and are a major cost of the project, a lessor should assess the probability that the project might be unsuccessful. Will it then be satisfied with being an unsecured creditor without any claim on specific assets of the lessee? If the project is terminated, a lessor may want to have the full repayment of all monies advanced plus costs, including interest compensation.

Myth 8. A Lessor Should Not Finance Customized Software.

If a lessor concludes that software obtained through a nonexclusive, nontransferable license is indispensable to business operation, the same logic applies to 100% (or a lesser percentage) customized software. The only issue is obtaining a security interest. If a copyright is registered, then a lessor must have its security interest recorded with the U.S. Copyright Office. It is not that difficult or time-consuming.

It may also be worthwhile to file at the state level because there is a period during development when the continuing work may not be covered by the copyright. If the software is not registered, the only place one can file is in the appropriate UCC jurisdiction; however, a lessor should consider how to protect itself if the software is subsequently registered with the Copyright Office.[15]

Myth 9. A Lessor Should Get Title to the License, Just as It Would for Equipment.

There is an unstated assumption in the leasing industry that the lessor should have title to whatever is leased, which is certainly necessary in operating leases. It is not necessary in capital leases, however, where what you need is a security interest and title is irrelevant – either you are secured or you are unsecured. In fact, the heading of Revised UCC Section 9-202 is "Title to Collateral Immaterial"!

Most licenses are nontransferable, so the lessee cannot legally assign the license to the lessor. It's possible that the license could be granted to the lessor with a right to sublicense to the user or lessee, but it seems to be rarely done. Most users will probably not allow another party to get between themselves and the developer. There are numerous issues that would have to be resolved between the developer and the lessor, and the lessor would be exposed to warranty claims and

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other claims by the user unless complex and time-consuming agreements were worked out with the user.[16]

What this means is that the normal lease documents providing for title in the lessor should be redrafted if the lease is to reflect the fact that the lessee has title to the license.

Myth 10. The Lessor Obtains a Purchase Money Security Interest Just Like Equipment.

This myth is for most lessors an unstated assumption. However, the Revised UCC, in one of its more dubious provisions, provides that a purchase money security interest (PMSI) can be obtained only in goods, software is not a "good," and therefore one can not obtain a PMSI in software. This followed the Old UCC.[17] So old law took precedence over common sense. But it didn't have to be that way. Canadian law allows a PMSI in software.[18]

The result: if there is a blanket lien, get the consent of the blanket lien holder that your security interest takes priority over the blanket lien. There is rarely a problem obtaining one, probably because lenders are accustomed to a lessor obtaining a PMSI for equipment, but the step should not be necessary.

Myth 11. A Lessor Can Do Only Small-Ticket Deals or Large Investment-Grade Deals.

When software leasing was a new product, most lessors and lenders limited software lease to investment-grade lessees. The credit risk was minimal and thus it did not matter what was being leased or what the resale value might be. On the other hand, small-ticket lessors didn't lease software, mostly because they didn't understand the product or the legalities or they had a concern about saleability in the case of default.

Today most lessors still limit software leasing to large transactions for investment-grade lessees, although a number have reduced their credit criteria somewhat. Many small-ticket lessors now generally lease software, although their lease documents generally still do not reflect that title to the license is held by the lessee.

Leases falling between these two areas are not effectively covered by software lessors and lenders. Analytically, the standard for leasing software for transactions falling between investment grade and small ticket should be relatively simple. Because the software is essential to operating a business, you can lease software if you believe the lessee will not be liquidated during the lease term. That is somewhat different from the normal credit approach, but that's what the decision is really about. It's about negative leverage on the lessee: that is, the lessor should be able to force the lessee to pay on the threat that the lessee will lose use of the asset if payment is not made. Consequently, the "gap" area represents an opportunity for lessors.

Myth 12. Since the License Is Nontransferable, a Lessor Cannot Structure an Operating Lease.

If a lessor accepts that most software is essential and has a long economic life (as support contracts result in the software always being up-to-date), then a lessor could structure operating leases of software, figuring that the lessee will renew the lease. There have not been any reports of lessors doing that, other than some vendors at times, primarily because the vendor's out-of-pocket cost, other than selling costs, is minimal. A lessor might obtain the consent of the vendor to allow it to remarket a license on an operating lease. There have not been any recent reports of that either.

A few operating leases have been completed where the lessor has obtained a blind discount from the vendor, but those occasions were ones where the lessee needed an operating lease that would qualify under FASB 13 (Federal Accounting Standards Board). In addition, licenses for a defined term are financeable, but then at lease termination the lessee has to negotiate a new license from the vendor.

Myth 13. Software Vendor Executives and Sales Personnel Understand Leasing.

One would think that executives and sales personnel in the software industry would have an understanding of leasing. After all, they are part of the computer industry, in which leasing is a way of life. Not so! Most software industry personnel

do not have leasing experience unless they come from one of the large software companies that has been leasing for years. There are exceptions, of course, but not many. What this means is that one can explain leasing to the executives, but then the real educational need is to show the sales personnel how to lease and why it benefits them.

Myth 14. A Lessor Needs Vendor Approval to Finance the License.

Some vendors require their approval for a lessor to finance each license and to enter into a three-party agreement for each lease. One very large public vendor has required the lessor to forgo taking a security interest in the license (apparently through a paranoid belief that a bankruptcy judge, in his desire to assist the bankrupt, will permit the license to be transferred in violation of the explicit license provisions).

Unless the license specifically requires such an agreement, it is not necessary, and Revised UCC Sections 9-408(a) and (c) provide that a licensor's restriction on a licensee granting a security interest in the license is not enforceable. However, Revised Section 9-408(d) does provide that a lessor or other financier cannot transfer the license in violation of the license.

Myth 15. A Lessor Should Get Vendor Remarketing Assistance, as It Does for Equipment.

Lessors that arrange leasing programs with equipment vendors have for years obtained remarketing assistance. They are a rarity in software leasing programs, primarily because SOP 97-2 of the American Institute of Certified Public Accountants (originally and as amended and clarified by FASB's Emerging Issues Task Force abstracts) denies sales treatment to a vendor that has even the hint of an obligation to the lessor, even if compensated for remarketing assistance. In addition, because the cost of reproduction of software for sale (normally a computer disk) is negligible, the vendor would be forgoing a high-margin sale if it directed the lessor to a prospect.

CONCLUSIONS

If the reader believes there is at least some merit in this debunking of the myths of software leasing, he should investigate the arguments more thoroughly.

The lessor should seriously consider entering the software leasing marketplace. It will take an investment in time and expense as well as in the training of personnel – particularly credit personnel – to accept software leasing as a viable product. In fact, carried to the logical conclusion, software leasing is superior from a credit and collateral standpoint to most types of equipment leasing. It does not depreciate in value over time and in most cases the lessee must make the lease payments because it would be difficult, if not impossible, to operate the business without the software.

The software vendor should seriously consider entering into discussions with a leasing company to see if it makes sense from a business standpoint to offer the leasing alternative to its prospects. After all, the computer hardware industry has grown with leasing, so why not the computer software industry? A portion of the vendor's customers will most certainly benefit from a leasing alternative, whether for cash flow, budgetary, or convenience aspects.

And the user, the potential lessee? Most of the reasons for leasing apply to software as well. Exploration of the leasing alternative may well prove beneficial.

So it seems that all the stakeholders in this area can benefit. All they have to do is determine whether these myths of the past are in fact real obstacles – or merely myths.

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Endnotes

1. The oldest articles the author found a number of years ago were from 1990. Most are not available through the Internet.

2. But see *In re CNB International Inc.*,307 B.R. 363 (W.D.N.Y.2004) available at: www.nywb.uscourts.gov/decisions/clb/0_In_re_CNB_International_Inc.pdf, in which the Bankruptcy Court held the lease contract was a contract sui generis, probably because the lease contract neither met the requirements of a true lease (lessor never had title to anything to lease) or a secured financing (no UCC filing was made and the court confused the software intellectual property and the software license). The decision is being appealed.

3. UCC Sec. 9-109(a)(1).

4. UCC Sec. 9-102(42).

5. UCC Sec. 9-102(42).

6. UCC Sec. 9-102(75).

7. UCC Sec. 9-102(44).

8. For an extended discussion of the issue, see Ronald J. Mann, "Secured Credit and Software Financing," *Cornell Law Review*, vol. 85, no. 1 (1999), pp. 143-147, and Scott J. Lebson, "Security Interests in Intellectual Property: Are They Really Secure?" available at: www.ladas.com/ipprop/ipprop_securityinterests.html (2006).

9. *National Peregrine Inc. v. Capitol Federal Savings. & Loan Assn. (In re Peregrine Entertainment Ltd.)*, 116 B.R. 194 (C.D. Cal 1990).

10. *Aerocon Engineering Inc. v. Silicon Valley Bank (In re World Auxiliary Power Co.)*, 303F.3d 1120 (9th Cir.2002).

11. 17 U.S.C. Secs. 101 et seq.

12. 17 U.S.C. Secs. 101 and 205.

13. *Associates Capital Corp. v. Rash*, 520 U.S.953 (1997).

14. *Preferred Capital v. Power Engineering Group Inc.* 2005-Ohio-5113(Ct. App 9th Dist., Sept. 28, 2005. Relating to forum selection clause. For additional background, see: www.pattonboggs.com/newsletters/bln/Release/bln_2005_10.htm and 2005_2.htm.

15. For some suggestions, see Terence A. Dixon, *Unregistered Copyrights*, available at the Dechert, LLP website: www.dechert.com/practiceareas/practiceareas.jsp?pg=lawyer_publications_detail&pa_id=39&id=2461.

16. For a discussion of license and sublicense structures, see William S. Veatch, "Software Leasing: The Intricacies of the Intangible," *Journal of Equipment Lease Financing*, vol. 14, no. 2 (Fall 1996).

17. UCC Sec. 9-105.

18. For example, Sec. 1(1) of the Ontario Personal Property Security Law defines a PMSI to attach to collateral that it defines as personal property, the definition of which includes intangibles.

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