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THE IMPACT OF BUNDLING ON EQUIPMENT LEASE SYNDICATIONS FROM THE PURCHASER'S PERSPECTIVE

By Philip R. Rosenblatt, Stephen J. Patterson, and Richard S. Rosenstein

The practice of bundling equipment acquisition financing with services and supply contracts is here to stay. However, the incremental risks that come with purchasing a bundled transaction must be properly understood and appropriately allocated.

FINANCIAL REPORTING ASPECTS OF BUNDLED TRANSACTIONS

By Shawn D. Halladay

Although bundled transactions are becoming more popular with customers, lessors must fully understand the accounting rules and ramifications.

TROUBLED LESSORS: IMPLICATIONS OF LESSOR INSOLVENCY ON VENDORS, ASSIGNEES AND LESSEES

By Susan G. Rosenthal

In the wake of recent court rulings, a lessor's insolvency will have certain effects on other parties. Vendors, assignees, and lessees have various options and strategies to preserve their financial interests and avoid litigation.

SOFTWARE LEASING REVISITED: PROPOSAL FOR A UCC ARTICLE 2A "SOFTWARE FINANCE LICENSE"

By William S. Veatch

Best practices have developed for the leasing of integrated systems of hardware and software, and some court cases have addressed the issues of software leasing. So now is a good time for equipment lessors and attorneys to look at statutory reform.



Software Leasing Revisited: Proposal for a UCC Article 2A “Software Finance License”

By William S. Veatch

The topic of software leasing continues to perplex equipment lessors, as there is a gap in the Uniform Commercial Code (UCC) when it comes to the financing of software licenses.¹ Currently unresolved issues in the world of software finance include the following:

- Is it possible to have a “true lease” of software under UCC Article 2A or at common law?
- What is the proper way to document a software lease?
- What is the difference, if any, between a lease and a license of software?
- Is the lessor’s right to terminate the software license upon a default enforceable?
- How much software can be included in an equipment lease before the entire lease no longer qualifies as a UCC Article 2A lease?
- Is a purchase option in a lease enforceable with respect to financed software?
- Will the lease be treated as a “true lease” in bankruptcy?
- Should software be put on a separate schedule from equipment? If so, will the software schedule constitute chattel paper?
- What is the effect on the sale, syndication, and securitization of lease portfolios if software is leased or financed under an equipment lease?

The purpose of this article is twofold: (1) to suggest an approach to analyzing the issues involved in a “true lease”

of an integrated system consisting of hardware and software under current law and (2) to suggest legislative reform, based largely on the provisions of the Uniform Computer Information Transactions Act (UCITA), which would help to clarify the legal rules relating to software leasing. Best practices for leasing and financing software have developed in the leasing industry, such that there is now a body of experience that could guide the effort to codify the software leasing rules as part of the UCC.

This article starts with a summary of the key provisions of a software finance license proposal (the “proposal”), with a proposed draft of the software finance provisions set forth in the appendix at the end of the article (page 9). Following the summary of the software finance lease proposal

are several examples of common software financing and leasing structures, which illustrate how the proposal would operate in practice.

SUMMARY OF THE SOFTWARE FINANCE LICENSE PROPOSAL

New Concepts: Software Finance License and Software Financial Accommodation

Under the proposal, a lessor could insert itself into the “chain of title” of the software license, thereby creating a

Now that best practices have developed with respect to the leasing of integrated systems of hardware and software and some reported court cases have addressed the issues associated with software leasing, it is an opportune time for the equipment leasing and legal professions to address possible statutory reform.

“true lease” of software, by providing notice to the licensor of the proposed software lease, but the lessor would not be required to obtain consent from the licensor. The lessor would become the licensee of the software for the sole purpose of sublicensing the software to the lessee, with the sublicense from the lessor to the lessee being defined as the “software finance license.”

The rationale for not requiring licensor consent is that, all other things being equal, the licensor should not care that the lessor is paying the price for the software on behalf of the lessee, so long as the licensor is not disadvantaged in any way.² The definition of “lease” would be modified to expressly state that a lease may include a software finance license.³

In addition to the software finance license concept, the proposal contains another new concept, a “software financial accommodation.” A software financial accommodation is essentially a loan included in a finance lease, to finance software and related soft costs on an unsecured or secured basis.⁴ This reflects the current practice in the leasing industry of financing some software and related soft costs under an equipment lease, even though the software and related soft costs are not technically “leased.”

However, the proposal includes a cap on software financial accommodations and other related soft costs in an amount equal to 20% of the total cost of equipment and software covered by the particular lease. The reason for including this concept in the proposal is that many finance leases do include a software financial accommodation, but there is no clear test for how much software and other soft costs can be financed without tainting the characterization of the lease as a “true lease” governed by UCC Article 2A.

Scope

Under the proposal, only nonexclusive licenses of software are covered.⁵ In addition, only software that is used in equipment leased pursuant to a “finance lease” (as defined in UCC Article 2A) is entitled to software finance license status.⁶ In other words, the lessor must not select, manufacture, or supply the goods or the software used in the goods. However, as is the case under current law

with respect to finance leases of equipment, a captive finance subsidiary of a software developer would be able to enter into finance leases and related software finance licenses, so long as the other elements of the definition of “software finance license” are satisfied.

Benefits to Lessor

The principal benefit of the proposal to the lessor is that the lessor would have a clear right to terminate the sublicense if the lessee is in breach of the lease.

The principal benefit of the proposal to the lessor is that the lessor would have a clear right to terminate the sublicense if the lessee is in breach of the lease. Under current law, if the lessor is not in the chain of the license, there is some question regarding the enforceability of the termination right.⁷ In addition, under the proposal the integrated finance lease of equipment and software finance license would clearly constitute a UCC Article 2A lease, and would be characterized as such in a lessee bankruptcy, to the extent that

the Bankruptcy Code looks to the UCC definition for the proper characterization of a lease. Furthermore, a lessor seeking to sell or finance a portfolio of finance leases that includes software could rest assured that the portfolio would clearly fall within the UCC Article 9 definition of chattel paper, allowing the lessor to take advantage of the special priority rules governing chattel paper.

In addition, as in the case of a finance lease of equipment, there would be a statutory disclaimer of any warranties or other obligations being made or assumed by the lessor with respect to the software. The lessor would be taking no greater risk with respect to the software than it does under current practice, where the lessor typically takes an assignment of rights under an equipment purchase contract.⁸

There would also be a statutory hell-or-high-water provision, stating that upon the lessee’s acceptance of the license or the lessor’s giving of value, whichever occurs first, the lessee’s payment obligation would become irrevocable and independent.⁹ Furthermore, there would be an express validation of the lessor’s termination right upon a lease default, both in the case of a software finance license and a software financial accommodation.

Finally, if the lessor has rights in the software, it is possible to structure a lease that includes a valid purchase option with respect to the software. For example,

if lessor purchases a perpetual license, a finance lease could include a term software finance license together with a right to purchase a perpetual license at the end of the lease term. If the lessor does not have any rights in the software, a purchase option in a lease is probably unenforceable to the extent that it relates to software, as the lessor has nothing to sell.

Benefit to Lessee

As with a finance lease of equipment, where the lessee benefits from a statutory pass-through of warranties from the supplier,¹⁰ the lessee would benefit from a statutory pass-through of warranties and other license provisions from the licensor of the software. Furthermore, if the rules governing software leasing are clarified, it should result in easier access to capital to finance software, which is an ever-increasing amount of a lessee's budget.

Addressing Concerns of the Intellectual Property Owner

The proposed software finance license and software financial accommodation concepts are based on similar concepts that appear in UCITA. During the drafting process, UCITA received considerable comment from both major software companies and the equipment leasing industry as well as from organizations representing users of software. As a result, these concepts reflect an attempt at a fair compromise that is intended to protect the interests of all parties involved. In particular, the lessor does not have a right to remarket the software upon a default or at lease termination, without the consent of the intellectual property owner. Such consent could be specifically negotiated, or it could be included in the license terms from the software supplier, such as in a license that by its express terms is transferable with a transfer of the equipment in which it is used.¹¹

In addition, the proposal would provide that the license terms would flow through to the lessee, so that notwithstanding the presence of the lessor in the chain of the license, the lessee would be directly obligated to the software supplier pursuant to the terms of the license.¹²

Relationship to Other Disciplines

The software license proposal does not take anything away from the scope of UCC Article 9, as any transac-

tion that creates a security interest will continue to be governed exclusively by UCC Article 9. UCC Article 9 would in fact benefit from the clarification that software can be licensed pursuant to a UCC Article 2A lease, in that a finance lease paired with a software finance license would more squarely fall within the current definition of chattel paper in UCC Section 9-102.

Note that the definition of "goods" in UCC Section 9-102 includes the following statement:

The term also includes a computer program embedded in goods and any supporting information provided in connection with a transaction relating to the program 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 acquires a right to use the program in connection with the goods.

However, for two reasons, most software that is bundled with leased equipment will not meet this test. First, federal intellectual property law preempts state law, so the federal intellectual property laws that protect owners of patents and copyrights will govern over the UCC. Second, except in the limited circumstances discussed in

this article, most license agreements are crafted to prevent the software program from being considered part of the goods or automatically transferring with the goods.

Therefore, while the concept of "embedded software" is attractive to banks and lessors, it is unlikely to provide a solution to the software leasing

dilemma. The proposal, on the other hand, reflects a compromise among the interests of the intellectual property owners, the financiers, and the users of the software; therefore, it ought to stand a good chance of being approved by all constituencies.

The proposal would address only the commercial law definition of a software lease; it would not directly affect the tax or accounting definitions of a software lease, which are based on different tests and are set to achieve different goals. For example, from a commercial law standpoint, the lessee does not become the owner of the intellectual property licensed under a nonexclusive license, so it would not be appropriate to recharacterize the license as a loan where the lessee owns the intellectual property. The license itself is not a property interest

UCC Article 9 would in fact benefit from the clarification that software can be licensed pursuant to a UCC Article 2A lease.

that can be owned; it is more properly viewed as a right to use the intellectual property without being sued for infringement. Unless there is a strong reason to do so (which does not appear to be the case in the context of a finance lease), as a policy matter the UCC and the courts should not overturn the characterization of a transaction that purports to be a license.¹³

The tax and accounting issues are different, however, in that they are looking at issues such as which party should get the tax benefits associated with the license, such as deducting the cost of the license for tax purposes and how the license and financing arrangement should be reported on the parties' financial statements. The tests used and the results obtained, however, need not be the same under the UCC, the tax rules, and the accounting principles, given the very different issues involved.

As mentioned above, federal intellectual property law would continue to preempt state law, so there would be no material impact on such federal laws.

Is Software Leasing Really a Form of Unsecured Financing From a Credit Standpoint?

Whether or not software leasing is best viewed as unsecured financing from a credit standpoint depends on the facts and circumstances of the particular transaction. However, there are some general observations that can be made in the context of the proposal:

- Whether a license is transferable upon a lessee default or at the end of the lease term will depend on the terms and conditions of the license, together with any consent obtained from the software owner, so it is important to read the license carefully.
- A software financial accommodation could be structured as a secured transaction. The software owner's consent would be required to remarket the software, but in a lessee bankruptcy, the security interest would attach to any proceeds of the license if the license were transferred with appropriate consents.

- A software finance license would give the lessor an enforceable right to terminate the license upon default to prevent unjust enrichment of the lessee, and it could provide the lessor with superior rights in a lessee bankruptcy.

Therefore, from a credit perspective, the noncancelable license payments during the term of the lease might be

viewed as an unsecured obligation or as something better than unsecured, particularly if the software is "mission critical" and difficult to replace with a competing product, such that a lessee would be likely to affirm the contract in the event of a lessee bankruptcy.

In terms of residual risk, however, a prudent lessor should not take residual risk in software unless either there are clear remarketing rights consented to by the software owner or the lessor determines that the risk of the lessee not exercising its purchase option is low. As discussed further below, there are a number of examples of transaction structures where software licensors are willing to grant consent to the transfer of software in connection with the remarketing of an integrated system of equipment and software.

A prudent lessor should not take residual risk in software unless either there are clear remarketing rights consented to by the software owner or the lessor determines that the risk of the lessee not exercising its purchase option is low.

HOW THE SOFTWARE FINANCE LICENSE PROPOSAL WOULD WORK

To illustrate how the software finance license proposal would work, set forth below are a number of common transaction structures and an analysis of how the proposal would affect existing practices.

Finance Lease of Technology Equipment, Including Operating System Software Used in the Equipment

Under current practice, operating system software typically is not transferable without consent, although it is important to read the license agreement for the particular vendor in order to confirm whether this is the case for the particular vendor's software product. If consent is not obtained (and if the lessor chooses not to send the notice required for a software finance license under the

new proposal), then under the proposal, the financing would constitute a software financial accommodation and could be included in a finance lease of equipment, so long as the aggregate software financial accommodation did not exceed 20% of the aggregate lessor's cost under the lease.

Ordinarily, this would not be a problem for operating system software (Figure 1). In these circumstances, lessors typically include a statement in the lease to the effect that the software is not being leased by the lessor to the lessee, but rather the software is being financed under the lease, and the lessee's right to use the software is obtained directly from the software supplier pursuant to a license agreement.

Under the proposal, however, the lessor would have the option of sending a notice to the software supplier stating that lessor was going to be financing the software through a software finance license as part of a finance lease of the equipment in which the software is used (Figure 2). This would have, in essence, no adverse affect on the software supplier or lessee, but it would give the lessor a clear right to terminate the license upon a lessee default. The combined finance lease and the software finance license would be treated as chattel paper and as a true lease in a lessee bankruptcy.

Finance Lease of Technology Equipment, Including Expensive Application Software Used in the Equipment

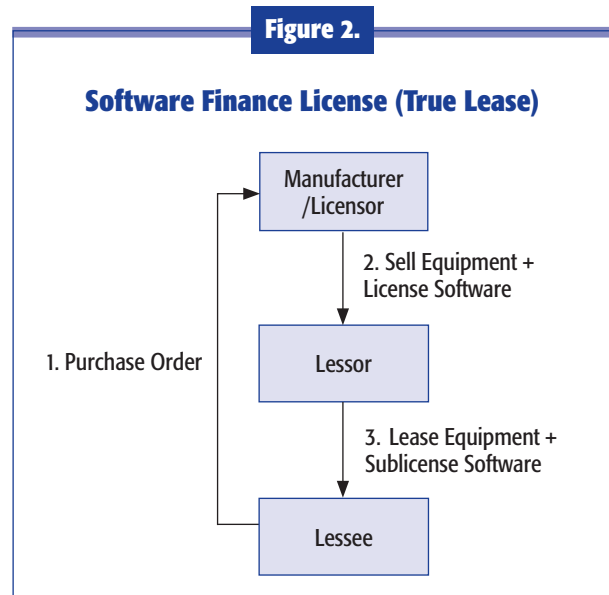
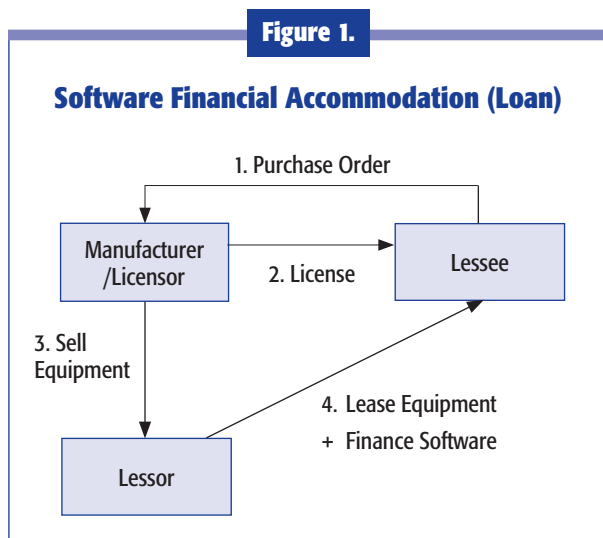
Under current practice, lessors are faced with a dilemma if the application software in an integrated system is expensive, often exceeding 50% to 60% of the total cost of equipment and software under the lease. It is unclear,

for example, whether the characterization of the entire lease could be tainted by including the software, or whether a court would sever the lease, treating part as a true lease of equipment and part as a loan to finance software. Therefore, some lessors separate out the equipment and software on separate lease schedules, treating the equipment schedule as a true lease and the software schedule as a loan.

However, this is not a satisfactory arrangement, given that the equipment and software in our example form an integrated system—one that should be subject to a single set of rules and remedies. To further compound the problem, the software-only schedule would not constitute chattel paper under the current UCC Article 9 definition, as

there is no "chattel," so the chattel paper superpriority rules that financiers of chattel paper often rely on would not apply.

Some lessors separate out the equipment and software on separate lease schedules, treating the equipment schedule as a true lease and the software schedule as a loan. However, this is not a satisfactory arrangement.



Under the proposal, the lessor could, by notice to the software supplier, create a software finance license for the purpose of leasing the entire integrated system pursuant to a single true lease. The lessor would still need consent of the software owner to remarket the software upon a default or termination of the lease, but the right to terminate the license would be clearly established.

Under current practice, there is a wide range of experience in terms of what remarketing rights the software vendor may agree to, including the following possibilities:

- The software is freely transferable along with the original equipment.
- The software is transferable upon a lease default, but only for the remaining lease term.
- The software is transferable with the original equipment for a reduced license fee.
- The software is transferable, provided that the new customer pays the full price for the software license.

Of course, maintenance of the software is another important issue, and the new customer in a remarketing will, for many types of software, require a maintenance contract, providing significant ongoing revenue to the software vendor. Therefore, software vendors often have an incentive to cooperate with the lessor to lock in the

new customer, particularly where there is a competing product that the lessee could select.

Sale and Lease, License-back

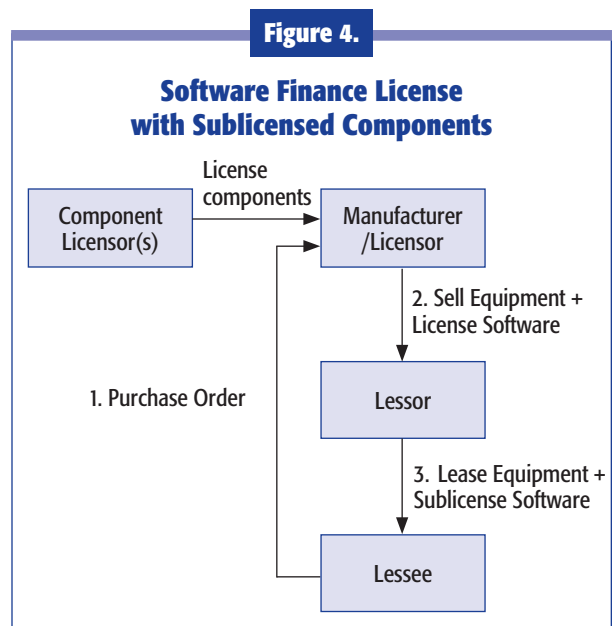
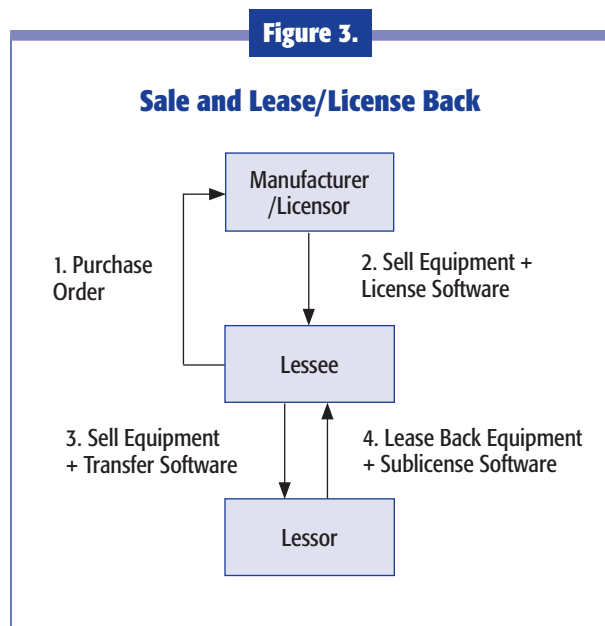
For the sake of completeness, the proposal would also allow for a sale and leaseback (with respect to equipment) and license-back (with respect to software). (See Figure 3.)

Sublicensed Components—Licensee in the Ordinary Course

Another important issue for lessors to be aware of is that licensed software often includes components that have been licensed to the software supplier from other software developers (Figure 4). Therefore, anytime that a lessor is negotiating a license or remarketing rights, it is important either (1) to conduct appropriate due diligence on who owns the underlying intellectual property and whether there are any inbound licenses incorporated in the product, or (2) to obtain appropriate representations from the software supplier in the license to the effect that it has the power and authority to grant the license and agree to any remarketing rights.

The issues relating to inbound licenses also highlight the need for legislative reform. Specifically, it is impractical to expect that all of the necessary parties will be

The issues relating to inbound licenses also highlight the need for legislative reform.



at the table when the lease is being negotiated, and even if they were, in many cases the various licensors would have no incentive to cooperate with the lessor, in terms of consenting to the license-sublicense structure. Therefore, under the proposal, a single notice to the software supplier would be sufficient to create a software finance license.

Financing, Sale, and Securitization of Lease Portfolios

As mentioned earlier, there are several potential issues concerning the definitions of “lease” and “chattel paper” that arise in the context of a sale of a lease portfolio. Under current law, a UCC Article 2A lease cannot include any software.¹⁴ If software is included, it is unclear whether the entire lease is tainted or whether a court would sever the lease and treat part as a true lease and part as a loan, or possibly an unsecured executory contract.¹⁵ Read literally, the UCC Article 9 definition of chattel paper appears to exclude an equipment lease that includes a software financial accommodation and also excludes a lease that covers only software.

On the other hand, an equipment lease that includes a software finance license would fall squarely within the current UCC Article 9 chattel paper definition. What this means is that a buyer of a lease portfolio should conduct due diligence on the portfolio to determine whether software is included, and the buyer should be wary of relying on the chattel paper superpriority granted to buyers in the ordinary course for value and without notice, as the normal rule in UCC Article 9-330 may not apply to leases including software.

If a buyer must rely on perfection by filing rather than taking possession of the original chattel paper, the buyer must also conduct UCC searches and obtain releases from any creditors with a prior lien of record. This is a significant change in the way that much of the leasing industry operates. Allowing a UCC Article 2A lease

to include a software finance license or software financial accommodation would preserve the traditional practice of buying and selling lease portfolios by transferring possession of the original chattel paper, without the necessity of conducting UCC searches and obtaining releases.

Note that even if a lease portfolio is sold in a “true sale” transaction, that does not mean that the buyer will necessarily have priority over creditors of the seller of the portfolio. This may seem counterintuitive at first, but “true sale” and “priority” are two distinct issues, and an unperfected true sale may not have priority. Therefore, to ensure priority when purchasing a lease portfolio, it

is critical to properly characterize the lease portfolio as either chattel paper, instruments, accounts, payment intangibles, or some combination of the foregoing, and then confirm that appropriate steps were taken to perfect the sale.

For example, a sale of a payment intangible (e.g., an unsecured loan to finance software) or promissory note (e.g., installment payment agreement used to finance software) is automatically perfected upon attachment under UCC Section 9-309, but there is disagreement among experts as to whether a UCC-1 financing statement is also effective to perfect the sale and establish priority—for example, under a sale program where there are ongoing sales and purchases of receivables.¹⁶

If a UCC-1 financing statement is not effective in the context of a sale of payment intangibles or promissory

notes, then the buyer must run a new UCC search against the seller prior to each sale in order to ensure priority.¹⁷ These perfection and priority issues affect both one-step sales of lease portfolios and two-step securitization structures, where the lessor sells the leases to a wholly owned special purchase entity, which then finances the portfolio with a loan.

If a UCC Article 2A lease could include both a software finance license and a software financial accommodation, the lease would clearly constitute chattel paper and there would be more certainty in terms of what rules

A buyer of a lease portfolio should conduct due diligence on the portfolio to determine whether software is included, and the buyer should be wary of relying on the chattel paper superpriority granted to buyers in the ordinary course for value and without notice.

of perfection and priority apply in connection with the financing, sale, and securitization of lease portfolios that include software.

CONCLUSION

Now that best practices have developed with respect to the leasing of integrated systems of hardware and software and some reported court cases have addressed the issues associated with software leasing, it is an opportune time for the equipment leasing and legal professions to address possible statutory reform. The benefits to equipment lessors would include (1) establishing a clear right to terminate the software license upon a breach of the lease; (2) clarifying the rights of a lessor with respect to software in the event of a lessee bankruptcy, and in particular clarifying that payments for the use of software sublicensed under a finance lease will be treated in the same manner as rental payments for the use of the leased equipment; and (3) clarifying the definition of “lease” so

that the “chattel paper” definition in UCC Article 9 will clearly include finance leases that include both equipment and a software finance license and/or software financial accommodation.

Of course, a UCC definition of a software finance license is only the first step. It will be equally important to develop consistent tax and accounting treatment if software leasing is to develop and grow as an important tool in the equipment leasing industry. However, clarifying the legal rules is a necessary first step and need not be contingent on changes in the tax and accounting rules.

This article and the proposal included herein are not intended necessarily to be the final solution to the software leasing issues. Rather, they are intended to open up the topic once again for discussion in the leasing industry and to illustrate that true leases of software can be achieved.

“Proposal for a Software Finance License,” the appendix to this article, begins on page 9.

Appendix

PROPOSAL FOR A “SOFTWARE FINANCE LICENSE”

Legal Background

Software financing transactions that are structured as secured debt fall under UCC Article 9.¹⁸ For purposes of UCC Article 9, secured debt includes both loans that are secured by a grant of a security interest in a software license and leases that fail the test for a true lease.¹⁹ True leases or licenses of software are not expressly covered by the UCC. True leases of equipment or goods, on the other hand, are governed by UCC Article 2A. However, UCC Section 2A-103 defines a “lease” as a lease of “goods,” which does not include software. Proposed amendments to UCC Article 2A would go further and specifically exclude software from the definition of “lease.”²⁰

Sales of, and loans secured by, leases, which are a type of chattel paper, are governed by UCC Article 9. In fact, for purposes of financing leases, “chattel paper” is defined to include “a lease of specific goods, or a lease of specific goods and license of software used in the goods ...” Therefore, the types of lease transactions that are included within the definition of chattel paper are actually broader than the definition of a lease in UCC Article 2A, since under UCC Article 9, lease chattel paper can include a license of software, whereas a UCC Article 2A lease cannot.

As mentioned above, true leases and licenses of software are not covered UCC Article 9 or Article 2A. In 2001, there was an attempt to draft a new UCC Article 2B that would have covered software licenses, including certain software financing arrangements that do not fall within the scope of UCC Article 9. Proposed UCC Article 2B, although downgraded in status to a uniform law called the Uniform Computer Information Transactions Act, was completed but to date has been adopted only in the states of Maryland and Virginia. As a result, true leases and licenses of software are currently excluded from statutory coverage in most of the United States.

Proposal

With the above discussion as background, the author would like to propose a new UCC Article 2A definition of “software finance license.” The software finance license would have two components: (1) a special license from the software owner to the lessor for the purpose of facilitating the acquisition of the software license by the ultimate end-user lessee, and (2) a sublicense from the lessor to the lessee—that is, the software finance license. Because of the similarity to an Article 2A finance lease of equipment and the fact that technology equipment is often bundled with software, the author submits that it is appropriate to include this special type of license in UCC Article 2A.²¹

The proposed sections 2A-S1 through 2A-S5 below are based on UCITA sections 507 through 511, respectively. Other conforming changes to UCC Article 2A would be required, but they are omitted here so as not to overcomplicate this article.

Text for Modified Provision

“**Lease**” means a transfer of the right to possession and use of goods for a term in return for consideration, but a sale, including a sale on approval or a sale or return, or retention or creation of a security interest is not a lease. Unless the context clearly indicates otherwise, the term includes a sublease. A transaction that otherwise meets the definition of a Lease may include without disqualification: (i) a Software Financial Accommodation, and/or (ii) a Software Finance License; provided, however, that the cost of the license and related soft costs financed pursuant to a Software Financial Accommodation shall not exceed an amount equal to 20% of the aggregate cost of equipment, software, and related soft costs financed under such Lease.

Text for New Provisions

“**Software Finance License**” means a sublicense, from the lessor to the lessee, of software that is used in goods that are subject to a finance lease, with respect to which: (A) the lessor becomes a licensee of the software for the purpose of transferring or sublicensing the license to the lessee pursuant to the finance lease, and (B) the lessor does not select, create, or supply the information that is the subject of the license, own the informational rights in the information, or provide support for, modifications to, or maintenance of the information. A Software Finance License may be in any form, including a license or lease.

“**Software Financial Accommodation**” means an agreement contained in a finance lease: (i) pursuant to which the lessor obtains a contractual right to preclude the lessee’s use of the information or informational rights under a license in the event of breach of the lease, and (ii) where the lessor is not a licensee of such information or informational rights.

UCC Section 2A-S1: Software Financial Accommodation. If a lessor makes a Software Financial Accommodation, the following rules apply:

- (1) The lessor does not receive the benefits or burdens of the license.
- (2) The lessee’s rights and obligations with respect to the information and informational rights are governed by:
 - (A) the license;
 - (B) any rights of the licensor under other law; and
 - (C) to the extent not inconsistent with subparagraphs (A) and (B), the terms of the finance lease between the lessor and the lessee, which may add additional conditions to the lessee’s right to use the licensed information or informational rights. To the extent that a Software Financial Accommodation creates a security interest, such security interest is governed by Article 9 and not Article 2A of the Uniform Commercial Code.

UCC Section 2A-S2: Software Finance Licenses.

- (a) If the lessor under a finance lease becomes a licensee in connection with a Software Finance License, the following rules apply:
 - (1) The transfer or sublicense to the lessee is not effective unless:
 - (A) the license to Lessor is expressly transferable by its terms or the licensor consents to the transfer or sublicense to lessee; or
 - (B) the following conditions are fulfilled:
 - (i) before the lessor entered into the Software Finance License, the licensor received notice in a record from the lessor giving the name and location of the lessee and clearly indicating that the license was being obtained in order to transfer the contractual interest or sublicense the licensed information or informational rights to the lessee;
 - (ii) the lessor became a licensee solely to make the Software Finance License; and
 - (iii) the lessee adopts the terms of the license, which terms may be supplemented by the lease, to the extent the terms of the lease are not inconsistent with the license and any rights of the licensor under other law.
 - (2) A lessor that makes a transfer that is effective under paragraph (1)(B) may make only the single transfer or sublicense contemplated by the notice unless the licensor consents to a later transfer.
- (b) If a lessor makes an effective Software Finance License to a lessee, the following rules apply:
 - (1) The lessee’s rights and obligations are governed by:
 - (A) the license;
 - (B) any rights of the licensor under other law; and
 - (C) to the extent not inconsistent with subparagraphs (A) and (B), the Software Finance License, which may impose additional conditions to the lessee’s right to use the licensed information or informational rights.
 - (2) The lessor does not make warranties to the lessee other than the warranty under Section [quiet enjoyment—to be drafted] and any express warranties in the lease.
- (c) The inclusion of a Software Finance License or Software Financial Accommodation in a lease of goods that otherwise satisfies the definition of a finance lease shall not be a factor in determining whether such transaction is a Security Interest or a Lease under UCC Article 1-201/1-203.

UCC Section 2A-S3: Financing Arrangements: Obligations Irrevocable.

Unless the lessee is a consumer, a term in a Software Finance License or Software Financial Accommodation providing that the lessee's obligations to the lessor are irrevocable and independent is enforceable. The obligations become irrevocable and independent upon the lessee's acceptance of the license or the lessor's giving of value, whichever occurs first.

UCC Section 2A-S4: Remedies or Enforcement.

- (a) Except as otherwise provided in subsection (b), on material breach of a Software Finance License or Software Financial Accommodation by the lessee, the following rules apply:
- (1) The lessor may cancel the Software Finance License or Software Financial Accommodation, as the case may be.
 - (2) Subject to paragraphs (3) and (4), the lessor may pursue its remedies against the lessee under the Software Finance License or Software Financial Accommodation.
 - (3) In the case of a Software Finance License, the lessor may exercise the remedies of a licensor for breach of the license.
 - (4) In the case of a Software Financial Accommodation, the lessor may enforce a contractual right contained in the lease to preclude the lessee's further use of the information. However, the following rules apply:
 - (A) The lessor has no right to take possession of copies, use the information or informational rights, or transfer any contractual interest in the license.
 - (B) If the lessee agreed to transfer possession of copies to the lessor in the event of material breach of the lease, the lessor may enforce that contractual right only if permitted to do so under subsection (b)(1).
- (b) The following additional limitations apply to a lessor's remedies under subsection (a):
- (1) A lessor described in subsection (a)(3) or (a)(4) which is entitled under the lease to take possession or prevent use of information, copies, or related materials may do so only if the licensor consents or if doing so would not result in a material adverse change of the duty of the licensor, materially increase the burden or risk imposed on the licensor, disclose or threaten to disclose trade secrets or confidential material of the licensor, or materially impair the licensor's likelihood or expectation of obtaining return performance.
 - (2) The lessor may not otherwise exercise control over, have access to, or sell, transfer, or otherwise use the information or copies without the consent of the licensor unless the lessee or transferee is subject to the terms of the license and:
 - (A) the lessee owns the licensed copy, the license does not preclude transfer of the licensee's contractual rights, and the transfer complies with federal copyright law for the owner of a copy to make the transfer; or
 - (B) the license is transferable by its express terms and the lessor fulfills any conditions to, or complies with any restrictions on, transfer.
 - (3) The lessor's remedies under the lease, to the extent that they relate to the license, are subject to the licensor's rights and the terms of the license.

UCC Section 2A-S5: Financing Arrangements: Effect on Licensor's Rights.

- (a) The creation of a Software Finance License or Software Financial Accommodation does not place any obligations on or alter the rights of a licensor.
- (b) Neither a Software Finance License nor a Software Financial Accommodation attaches to any intellectual property rights of the licensor unless the licensor expressly consents to such attachment in a license or another record.

Endnotes

1. See William S. Veatch, "Software Leasing: The Intricacies of the Intangible," *Journal of Equipment Lease Financing*, vol. 14, no. 2 (Fall 1996) for an overview of some of the different structures used to finance software, and "Software Financing: The Perplexities of a Program Agreement," *Journal of Equipment Lease Financing*, vol. 15, no.2 (Fall 1997) for a discussion of software vendor finance programs.
2. This is the same approach that was taken in UCITA, i.e., licensor consent is not required for a lessor to insert itself into the chain of the license. However, to date, UCITA has not been widely adopted, so it would be preferable to make an appropriate amendment to UCC Article 2A.
3. See the modified definition of "lease" in the proposal set forth in the appendix. The current definition of lease is limited to "goods" and the amendments proposed to UCC Article 2A, but not yet passed in any state, would specifically exclude software. See www.law.upenn.edu/bll/archives/ulc/ucc2a/annual2002.htm for a draft of the amendments proposed to UCC Article 2A in 2002, at the annual meeting of the National Conference of Commissioners on Uniform State Laws.
4. For the purpose of clarification, a comment could be added to UCC Article 2A to the effect that UCC Article 9 will govern to the extent that a software financial accommodation creates a security interest.
5. The overwhelming majority of software licenses financed by lessors are nonexclusive. A nonexclusive license is essentially a "right to use" certain copyrighted or patented software without being sued for infringement, and it clearly is not a transfer of any ownership interest in the underlying software copyrights or patents. Since the license is nonexclusive, the owner of the copyrights and patents has the right to license the same rights to any number of other licensees. For UCC Article 2A purposes, the phrases "lease of software" and "license of software" mean the same thing, as both lease and license mean granting the "right to use." It follows that it does not make sense to "lease a license," but rather it is the right to use the underlying copyrights and patents that is leased or licensed.
6. This approach is consistent with the approach taken in the UCC Article 9 definition of chattel paper, which includes "a lease of specific goods and license of software used in the goods." Note that if the software is financed under the lease, but not licensed by the lessor to the lessee pursuant to the lease, it is unclear that the lease is in fact within the definition of chattel paper, read literally. The Permanent Editorial Board for Uniform Commercial Code, on Oct. 20, 1999, approved amendments to Comment 5.b to UCC Section 9-102, stating in part that "The monetary obligation with respect to the software need not be owed under a license from the secured party or lessor, and the secured party or lessor need not be a party to the license transaction itself. Among the types of monetary

obligations that are included in 'chattel paper' are amounts that have been advanced by the secured party or lessor to enable the debtor or lessor to acquire or obtain financing for a license of the software used in the goods." However, the comments, while persuasive, are not binding on a court, and it would be helpful to clarify that a UCC Article 2A lease can in fact include a software finance license or software financial accommodation without tainting "true lease" status.

A related question is whether or not a 100% lease financing of software should also be entitled to true lease treatment if certain conditions are met, but that question is beyond the scope of this article. Although this article is limited to discussing leases of "software used in the leased equipment," the concepts discussed in this article could be extended by analogy to leases where perhaps even 100% of the product financed is software.

7. In a software financing transaction, the lessor's principal remedy is the right to terminate the lessee's right to use the software upon a default. However, under current leasing practice where the lessor typically is not in the chain of the license, it is unclear that the lessor could enforce such a right to terminate the license. Unless a cross-default provision is specifically negotiated with the licensor, a lease default would not normally constitute a default under the license agreement. In addition, specific performance (i.e., the right to force the lessee to stop using the license in the absence of a license default) may not be available under local state law, given that money damages would appear to be an adequate remedy for the lessor.

Also, some UCC Article 9 scholars believe that a termination right would not be a valid UCC Article 9 remedy (assuming that lessor had a security interest in the license), because the secured party typically has no right to use or remarket the software, making the remedy appear punitive in nature. One response to that argument is that it is not fair for the debtor to be unjustly enriched through the continued use of the software that was paid for by the lessor or secured party. In any event, it is unclear under existing law whether the right to terminate the license would be enforceable if the lessor is not in the chain of the license.

8. Just as the equipment purchase agreement and warranties are not considered part of the chattel paper, it would be helpful to include a comment in the UCC confirming that the head license between the software supplier and lessor is not part of the chattel paper, for purposes of obtaining perfection by possession of the chattel paper.

9. See Proposal Section 2A-S3.

10. See UCC Section 2A-209 and Proposal 2A-S2.

11. This highlights the importance of reading the license carefully. Some licenses, such as for small-ticket consumer software products, are freely transferable, so long as the transferor does not keep a copy. In other cases, such as an integrated system of software and equipment, the software may be transfer-

able with the original equipment, so long as it is used only as part of the original integrated system. In still other cases, the software vendor may have a practice of accepting a reduced fee upon remarketing of the system. Of course, if the software vendor believes that the remarketing is in direct competition with its direct license program, then a full market fee may be required. The key practice point, however, is that it is critical for the lessor to read the license in order to determine what rights it has in the software, understand what the market standard is for such agreements, and then make an informed decision about what risks are acceptable and whether to attempt to negotiate some form of remarketing rights.

12. See Proposal Section 2A-S2.

13. It is possible to create a license that should, arguably, be treated as a secured loan. For example, a secured party seeking to avoid the foreclosure rules in UCC Article 9 might negotiate an exclusive license of certain patents and copyrights but covenant not to exercise its rights as licensee under the license unless there is a default under a loan agreement between the licensee, as lender, and the licensor, as borrower. Such a transaction might properly be recharacterized as a disguised secured transaction because (i) the exclusive license is functionally equivalent to ownership and (ii) the right to exercise the license is contingent upon a default by the licensor. However, this does not appear to be the case under the software finance license proposal, as the proposal covers only nonexclusive licenses, and the license rights are exercised immediately by sublicensing the software pursuant to the lease.

14. See UCC Article 2A-103 definition of lease. See also, the proposed amendments the UCC Article 2A discussed at note 3.

15. See *In re CNB*, where the court treated the failed software lease as an unsecured executory contract. In light of this case, it is prudent to always include a precautionary grant of a security interest in any lease that includes software.

16. While not completely free from doubt, the prevailing view among UCC Article 9 scholars appears to be that the filing of a financing statement has no effect for purposes of perfection or priority with respect to sales of promissory notes and pay-

ment intangibles perfected under UCC Section 9-309. This is true, notwithstanding that UCC Section 9-310(b) states that a financing statement is not “necessary,” but it does not say that it is “ineffective” to perfect a transaction that is perfected under UCC Section 9-309 when it attaches.

17. See Veatch, “Selling Lease Receivables in a Post-Enron World: True-sale Opinions and Revenue Recognition,” *Journal of Equipment Lease Financing*, vol. 21, no. 1 (Spring 2004), for a thorough discussion of true sale and related priority issues in connection with the sale of a lease portfolio.

18. See Mark Bazrod, “*Journal of Equipment Lease Financing*,” vol. 24, no. 3 (Fall 2006) for a discussion of software leasing where the lease is not a true lease but rather creates a security interest under UCC Article 9.

19. The test for a true lease versus a security interest is found in UCC Article 1, Section 1-203. In light of the decision in *In re CNB International Inc.*, 307 B.R. 363 (W.D.N.Y. 2004), however, which held that a software lease that failed as a true lease also failed as a secured transaction and therefore constituted an unsecured, executory contract, lessors should include an express grant of a security interest in any software license included in a lease.

20. The proposed amendments to UCC Article 2A would specifically exclude software from the coverage of UCC Article 2A by defining “lease” to mean: “a transfer of the right to possession and use of goods for a period in return for consideration, but a sale, including a sale on approval or a sale or return, retention, or creation of a security interest, or license of information is not a lease. Unless the context clearly indicates otherwise, the term includes a sublease.” However, to date, the proposed amendments have not been adopted by any state.

21. The software finance license proposal takes a similar approach to that taken in UCITA. However, the proposed addition to UCC Article 2A would cover only “finance licenses,” with the focus on only those licenses where the licensor is a sublicensor and is not the manufacturer or supplier of the software.



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