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# The Financing of Intellectual Property under Revised UCC Article 9

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# THE FINANCING OF INTELLECTUAL PROPERTY UNDER REVISED UCC ARTICLE 9

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*[The rule of section 9-318(4)] can be regarded as a revolutionary departure only by those who still cherish the hope that we may yet return to the views entertained some two hundred years ago by the Court of King's Bench.*[1]

Article 9[2] facilitates the ability of owners of rights in property to obtain financing secured by that property. The revisions to Article 9 seek to facilitate secured financing by

- simplifying the procedures for obtaining and perfecting security interests in personal property,
- bringing predictability and certainty to the results of these transactions, and
- lowering transaction costs.

At the same time, the Drafting Committee for Revised Article 9 (the "Drafting Committee") recognized that implementing these goals in connection with the creation and enforcement of security interests in rights in intellectual property will often affect the rights of third parties not parties to the transaction, such as the owners and users of the intellectual property. The Drafting Committee took great care to balance the overall goals of Article 9 with the interests of these persons.

The Drafting Committee extensively reviewed the methods of financing used for intellectual property.[3] This review included existing

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1. U.C.C. § 9-318 cmt. 4.

2. All references and citations in this article to UCC Article 9 are to Revised Article 9 unless otherwise indicated. For emphasis, this article frequently makes express reference to "Revised" Article 9. In the footnotes, Former Article 9 is cited as "U.C.C. § 9-XXX" while the revised Article is cited as "R. § 9-XXX."

3. Substantially all of the discussions on these issues involved software and motion picture financing. Most of the examples given in this article will involve those industries. These issues

and anticipated patterns of financing for this type of property. The Drafting Committee developed a set of rules that recognize and balance the rights of each of the persons affected by the creation, perfection, and enforcement of a security interest in rights in intellectual property.

This article reviews practices of financing secured by these types of property and how the Article 9 Drafting Committee addressed and balanced the interests of each of the persons affected by the transaction. The Drafting Committee arrived at a set of even-handed results.

## I. THE ARTICLE 9 DRAFTING PROCESS

The consideration of the issues discussed in this article generated more controversy than most provisions of Revised Article 9. This article will review how the Drafting Committee considered and resolved those issues.

The Article 9 Reporters, members of the Drafting Committee, and others directly involved in the Article 9 revision process had many communications with licensors and licensees of intellectual property, the Reporter and Drafting Committee Chair for the proposed Uniform Computer Information Transactions Act ("UCITA"),[4] the ABA's Intellectual Property Section, and other persons active in the UCITA process. Representatives of leading software financing institutions made presentations to the Drafting Committee. These communications provided very helpful information to the Drafting Committee and resulted in changes to the relevant provisions of Revised Article 9 to accommodate and balance the various interests.

The Intellectual Property Section of the ABA took an active role commenting on the provisions of Revised Article 9 that directly address intellectual property issues. That Section is very sensitive to the concerns of licensors of intellectual property, including software. That Section initially expressed some concerns about the provisions of Article 9 that directly affect the financing of intellectual property. In response to those concerns, the Drafting Committee made several important revisions and clarifications to Article 9 that are discussed

are not limited to those industries and the issues affect financing of many kinds of intangible property. For example, the Drafting Committee also took into account the interests of parties to governmental and private franchises and licenses not involving intellectual property.

4. UCITA was formerly referred to as UCC Article 2B. The relevance of UCITA is discussed below.

below. After extensive consideration of the issues, the Intellectual Property Section determined that Article 9 strikes an appropriate balance and decided to support Article 9.

## II. SCOPE QUESTIONS

### *A. General*

Article 9 does not apply to all financing of intellectual property nor does it apply to all aspects of the financing of intellectual property. This section will review the scope of the application of Article 9 to the financing of intellectual property.

### *B. The Application of Federal Law*

Intellectual property often exists in a form subject to federal regulation, such as copyright law. Recent decisions, primarily in the West, have held that the Copyright Act preempts the application of Article 9 to the extent that federal law supplies a different rule.[5] When the collateral is a copyright, the prudent secured party will likely seek to perfect its security interest both by recording a copyright mortgage in the Federal Copyright Office and by making a filing of a UCC financing statement in the appropriate state.[6] This article

5. *See, e.g.*, National Peregrine, Inc. v. Capitol Fed. Sav. & Loan Ass'n (*In re* Peregrine Entertainment, Ltd.), 116 B.R. 194, 199 (C.D. Cal. 1990); *In re* Avalon Software, Inc., 209 B.R. 517, 521 (Bankr. D. Ariz. 1997). However, the courts have consistently held that the UCC governs the perfection of a security interest in a patent or a trademark for purposes of defeating the claims of a lien creditor, including a trustee in bankruptcy. *See In re* Cybernetic Servs., Inc. v. Matsco, Inc., 239 B.R. 917 (B.A.P. 9th Cir. 1999) (patent); *In re* Together Dev. Corp., 227 B.R. 439, 442 (Bankr. D. Mass. 1998) (trademarks); *In re* Transportation Design & Tech., Inc., 48 B.R. 635, 639 (Bankr. S.D. Calif. 1985) (patents); *see also* R. § 9-109(c)(1) (recognizing federal preemption of Article 9 to the extent of actual preemption).

6. Section 9-316 provides (in part) that when a debtor transfers the "collateral" to a person "located" in another state, a security interest perfected by the filing of a UCC financing statement in the debtor's state becomes unperfected if the secured party does not file a UCC financing statement in the second state within one year. *See* R. § 9-316(a)(3). Some concern has been expressed that a secured party in a transaction would file a financing statement against an owner of intellectual property in the state of the debtor's location, probably the state of incorporation under Revised Article 9. *See id.* §§ 9-301, 9-307. The owner of the intellectual property would then enter into an exclusive license with a licensee in another state, and concern was expressed that the license would trigger this rule as involving a transfer of the *copyright* itself. If that were correct, the secured party would have to file a UCC financing statement in the new state within one year for every license. Under *Peregrine* and *Avalon*, the only way to perfect a security interest in a copyright and the proceeds of the copyright (including accounts) is to file a copyright mortgage under the Federal Copyright Act. *See In re Peregrine*, 116 B.R. at 199; *In re Avalon*, 209 B.R. at 521. These decisions (if correct) indicate that the filing of a UCC financing statement means absolutely nothing. Thus, under *Peregrine* and *Avalon*, section 9-316 (though not the UCC as a whole) is irrelevant to the perfection of a security interest when the intellectual property collateral is a copyright. Even if the UCC does apply to these transactions, a true

will generally review the effect of Revised Article 9[7] on these transactions and will identify the possible effect of federal law where relevant.[8]

## C. UCITA

The National Conference of Commissioners on Uniform State Laws ("NCCUSL") has approved a new uniform law, UCITA, to cover "computer information transactions."[9] UCITA has been approved by its sponsor.[10] Until the February 1999 draft of UCITA,

license of the right to use collateral (a copyright in this example) (under both copyright law and Article 9) is not a "transfer" of the "collateral" itself and does not give the licensee a property interest in the copyright itself. (Although the copyright is not transferred by the license, the rights created by the license are "property" for Article 9 purposes, and can serve as collateral should the licensee grant a security interest in them.) A security interest attaches only to the debtor's rights in the collateral. *See* R. § 9-203 cmt. 6. Some intellectual property lawyers have expressed concern that, as a matter of copyright law, under the Copyright Act the grant of an exclusive license transfers a "property" right to the licensee. *Nimmer on Copyright* analyzes the Copyright Act in a manner consistent with the Article 9 analysis. *See* 3 MELVILLE B. NIMMER & DAVID NIMMER, NIMMER ON COPYRIGHT § 10.02[C][2] & n.51 (1999) (commenting "there is never more than a single copyright in a work notwithstanding the author's exclusive license of certain rights"; "an exclusive licensee owns 'separately' only 'the exclusive rights comprised in the copyright' that are the subject of his license"; "particular 'exclusive rights under a copyright' do not in themselves constitute a 'copyright'"; and "there is but one copyright in a work regardless of whether and how many exclusive licenses of particular rights thereunder have been granted"). Thus, for Article 9 purposes, the licensee's property interest is in its rights under the license, not in the copyright itself. *Nimmer* makes clear that the licensor remains the "owner of the copyright" and has not transferred is property by entering into the license. Accordingly, Revised Article 9 produces the same result as copyright law—no filing is necessary by the secured party of the licensor against the exclusive licensee because the *copyright* itself has not been transferred to that person. Even if this analysis were wrong, there is no risk to the secured party because of section 9-321 (discussed in detail below). Under that section, a nonexclusive licensee takes its license "free" of the security interest. *See* R. § 9-321(b). However, an exclusive licensee obtains no special rights under Revised section 9-321. The secured party of the exclusive licensee gets a security interest only in whatever it is the licensee has. What the licensee has is a right subject to the security interest created by its licensor (including termination by a foreclosure by the secured party). So in the event of a foreclosure by the secured party of the licensor, the interests of the licensee and its secured party evaporate. Their interests are discharged by the foreclosure.

7. Revised section 9-109(c)(1) makes clear that Article 9 defers to federal intellectual property law only "to the extent" that federal law in fact preempts Article 9. *Peregrine* suggested that Article 9 deferred in its entirety whenever there was *any* federal rule that applied to a transaction. *See In re Peregrine*, 116 B.R. at 199-202.

8. This article will not consider whether decisions such as *Peregrine* and *Avalon* reach correct results. Under federal intellectual property law, a licensee under a nonexclusive license may not have a "property" interest for certain purposes. Any such rule, however, does not prevent a security interest under Article 9 from attaching to the licensee's "rights" under the license. For many decades, the courts have recognized that state law governs security interests in copyrights generally, even if copyright governs filing.

9. UNIF. COMPUTER INFO. TRANSACTIONS ACT prefatory note (1999). Drafts of UCITA are available at <http://www.law.upenn.edu/library/ulc/ulc.htm>.

10. This article cites the 1999 draft of UCITA, Approved and Recommended for Enactment in All States, unless otherwise indicated.

UCITA contained provisions that overlapped some of the provisions of Article 9 discussed in this article. Many of the provisions in UCITA were consistent with those of Article 9. Some were not.

Certain of the major policy issues involved in the financing of intellectual property were debated on the floor of NCCUSL at its annual meeting in July 1998 at the time of the approval of Article 9. The discussion included references to certain inconsistencies with UCITA on these points. All of this occurred before the discussion of UCITA. The policy results were approved during that discussion and vote on Article 9. Recognizing that NCCUSL had just set policy on these issues by adopting Article 9, the Chair of the UCITA Drafting Committee announced from the podium at the NCCUSL Annual Meeting that UCITA would be made "consistent" with Article 9.

In early November 1998, the UCITA Drafting Committee considered and debated the UCITA Reporter's and Chair's proposal to make UCITA "consistent" with Article 9 by eliminating all financing provisions from UCITA. No member of the UCITA Drafting Committee objected. The February 1999 draft of UCITA formally deleted these previsions, and the UCITA Drafting Committee approved those changes at its meeting in February 1999. The UCITA Drafting Committee also approved a provision in UCITA that now reads: "To the extent of a conflict between this [Act] and [Article 9], [Article 9] governs."[11] Thus, both the official text of UCITA and its drafting history make clear that Article 9 will govern all aspects of a secured transaction in intellectual property.

### *D. Is There a "Security Interest"?*

The "financing" of the rights of a licensee[12] of intellectual property may take a variety of forms. Some of the common financing structures do not create a security interest, and Article 9 does not apply to those transactions, leaving them to other law (including UCITA, if adopted in a state).[13] Article 9, of course, will govern a transaction if its substance is a transaction subject to Article 9, whatever form the transaction takes.

11. UNIF. COMPUTER INFO. TRANSACTIONS ACT § 103(c)(2).

12. Transactions in intellectual property typically involve the "licensing" (and not the "sale") of rights to use the intellectual property.

13. UCITA includes provisions addressing software financing transactions not subject to Article 9. *See* UNIF. COMPUTER INFO. TRANSACTIONS ACT §§ 103(c)(3), 507–511. This article does not discuss those provisions.

### 1. Software Licensor Finances the Licensee

The simplest structure provides for a software licensor itself to finance the licensee by allowing the licensee to pay for its rights under the license over time. Under this structure:

- The licensor enters into a nonexclusive[14] license of software with a licensee.
- The licensee pays the license fee in installments.
- The licensor has a right to terminate the license[15] if the licensee does not make a payment.[16]

### 2. Software Licensor's Affiliate Finances the Licensee Through a Sublicense

A variation on the first transaction is modeled on "finance lease" transactions under Article 2A.[17] These transactions proceed as follows:

- A software licensor enters into a nonexclusive license of software with a financier (often an affiliate of the licensor).
- The financier pays the licensor the fee for the license in full.
- The financier enters into a nonexclusive sublicense[18] of the software with the ultimate user-sublicensee.
- The sublicensee pays the financier for the sublicense in installments.
- The financier (sublicensor) has the right to terminate the sublicense if the sublicensee does not make a payment.

### 3. Third Party Directly Finances the Licensee Through a Loan to Licensee

The final principal variation involves a more traditional structure, with one important difference: there is a loan instead of a sublicense.

- The licensor enters into a nonexclusive license of software

14. The meaning of "nonexclusive" is discussed below. *See infra* Part V.C.

15. In this and the following examples, the "termination" right may be structured as an agreement by the person receiving the financing to stop using the software.

16. The "termination" provision may contain significant "liquidated damages" provisions designed to "encourage" the user of the software not to breach the agreement. This article does not consider the enforceability of those provisions.

17. *See* U.C.C. §§ 2A-303, 2A-407. In practice, parties to these software transactions often use "leasing" terminology.

18. This may be referred to as a "lease."

with licensee.

- The financier (often an affiliate of the licensor) makes a loan to the licensee.
- The licensee uses the loan proceeds to pay the fee for the license in full.
- The licensee repays the loan to the financier in installments.
- The financier has the right (under a covenant in the financier's agreement with the licensee or perhaps with the cooperation of licensor) to terminate the license if the licensee does not make an installment payment.

### 4. Yes, We Have No "Security Interest"

None of the transactions described in the preceding sections creates a "security interest." A licensor's right under a *non*exclusive[19] license on default to terminate the license is *not* a "security interest." The same conclusion should result from a review of the rights of a lender to the licensee that obtains termination rights against the licensee.

The essence of a "security interest" is "an interest in personal property or fixtures which secures payment or performance of an obligation."[20] If the creditor does not have an interest in personal property that the creditor can use to satisfy the debtor's obligation, a "security interest" does not exist. In each of the transactions described above, the creditor does *not* have anything it can use to satisfy the obligation:

- Where the license provides for deferred payments of the license fee and provides the licensor the right to terminate the license upon the licensee's failure to make a required payment, the transaction generally should not, standing alone, "create or provide for" a "security interest." The licensor's right to terminate does not give the licensor anything to sell that it could not already sell—*another* nonexclusive license.[21]

19. The analysis might well be different for an "exclusive" license. There the secured party of the licensee may have something of value to dispose of upon the licensee's default. The secured party's disposition of the licensee's rights may be subject to possible restrictions. *See infra* Part IV.

20. U.C.C. § 1-201(37). Revised Article 9 has not changed this portion of the definition of "security interest." *See* R. § 9-102(c).

21. The licensor under a nonexclusive license differs from a "lost volume" seller of goods under UCC section 2-708 in that the lost volume seller has something of value to resell—the goods that it manufactured. The licensor in this circumstance incurs no, or a nominal, marginal cost in entering into a new, additional nonexclusive license.

Because the license that the lender is terminating was a nonexclusive license, by definition the licensor can grant an infinite number of additional nonexclusive licenses, whether or not it terminates the licensee that is in default.[22]

- In the second transaction, the sublicense, the same analysis applies. The sublicensor has nothing of value to sell.
- In the third transaction, a third party provides credit to a nonexclusive licensee where the third party has an agreement with the licensee that requires the licensee to terminate[23] its use of the license (and perhaps to have the licensor cooperate in this endeavor) upon the licensee's default in its financial obligations to the third party. Similarly the third party does not have a "security interest." Where the license is a nonexclusive license, the financing party holding a termination right still does not have anything to sell if the licensee defaults.[24] It does not matter who holds the termination right if that person has no property to look to to obtain satisfaction of the obligation of the licensee to the creditor.

Some suggested during the Drafting Committee's consideration of this issue that the licensee in these circumstances needs *some* protection and thus Article 9 treatment is necessary to provide that protection.[25] Article 9 cannot and does not undertake to provide procedural protection to all persons who breach a contract and consequently lose rights under that contract. Article 9 does not provide protection in transactions not within its scope. The scope of Article 9, based on the definition of "security interest" for purposes of

22. UCITA recognizes that the licensor does not "reacquire" anything to resell. UCITA does *not* require the licensor of a *non*exclusive license to "re-license" the rights and credit the breaching licensee unless the breach "makes possible a substitute transaction." UNIF. COMPUTER INFO. TRANSACTIONS ACT § 808(b)(1)(B) (1999). That circumstance will rarely occur with a *nonexclusive* license.

23. Presumably the licensee's continued use of the license following her termination of use under that agreement would not only be in breach of that agreement, but also would infringe on the licensor's rights.

24. A licensor or a third party may, in addition to having a right to terminate a licensee's rights under a license, *also* have a security interest in the licensee's rights to secure the licensee's payment obligations. In that circumstance, the licensor or third party also has a "security interest" with respect to *that part* of the transaction. The existence of the security interest should not transform the portion of the transaction consisting of a termination right into a security interest. A *third party* holding a termination right *and* a security interest has value in holding the security interest because it has something to sell—the licensee's rights under the license. The secured party's right to enforce its security interest may be subject to restrictions in the license or under other law. *See* R. § 9-408(d).

25. UCITA will provide protection to the licensee. *See* UNIF. COMPUTER INFO. TRANSACTIONS ACT §§ 801-816.

Article 9, should not be stretched to cover these transactions for the purpose of providing protection to the licensee (any more than it should be stretched to enhance the rights of the financier).

If a right of termination alone does not create a security interest, then the person holding the termination right would *not* have to

- file a financing statement to protect its rights because no security interest exists,[26] or
- comply with the Article 9 foreclosure rules.[27]

There are, to be sure, transactions that the parties label a license that *do* constitute a "security interest."[28] For example, an agreement labeled an exclusive "license" that functions as an outright transfer of the licensor's intellectual property (e.g., a copyright) would likely constitute a transfer of ownership and, if the transferee were paying over time, a "security interest."[29] Thus, an exclusive, worldwide, perpetual license to use a copyright in all media, etc., would in substance function as a transfer of the copyright itself.

### *E. Goods v. Software*

Article 9 draws a line between "goods" and "software."[30] Where

26. Of course, a financing party might choose, as a matter of prudence, to file a protective financing statement in order to forestall litigation that might otherwise occur.

27. UCITA places certain limitations on the right of a licensor to use electronic self-help. *See* UNIF. COMPUTER INFO. TRANSACTIONS ACT § 816. Article 9 does not contain any similar provision. However, Article 9 secured parties enforcing their rights are subject to duties of commercial reasonableness and good faith. The courts have not been sympathetic to secured parties that stray from the rules. Revised Article 9 defines "good faith" to include the "observance of reasonable commercial standards of fair dealing." R. § 9-102(a)(43).

28. The form of the transaction is not determinative of whether Article 9 applies. *See* U.C.C. § 9-102(1) (Article 9 applies to a transaction "regardless of its form"); R. § 9-109(a) (same). Whether title to the personal property resides in one party or another is not relevant in determining whether Article 9 applies. *See* U.C.C. § 9-202; R. § 9-202. For example, transactions which are labeled by the parties as transfers of ownership, leases, bailments, consignments, or the like, or that adopt the structures of those transactions, are nevertheless governed by Article 9 when the economic effect of the transaction is to create an interest in personal property which secures payment or performance of an obligation. *See* U.C.C. § 1-201(37).

29. Revised section 9-505(a) provides that a person in a transaction that might be classified as a transaction subject to Article 9 may file a protective financing statement. It should be noted that this section specifically provides that a *licensor may* file a protective financing statement indicating its interest in a license. *See* R. § 9-505(a).

30. Section 9-102(a)(44) defines "goods" as

> all things that are movable when a security interest attaches. . . . 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. The term does not include a computer program embedded in goods that consist solely of the medium in which the program is embedded.

software is "embedded" in goods so that the software becomes "part of" the goods,[31] Article 9 treats the software as "goods" for *all* purposes under Article 9 (such as how to perfect a security interest and the buyer in ordinary course rules). When software maintains its independent status, it will constitute a general intangible.[32]

## III. THE LICENSOR'S TRANSFER OF ITS PAYMENT RIGHTS

### *A. How Does Article 9 Classify and Apply to the Licensee's Payment Obligations?*

#### 1. Current Law

Current Article 9 has always applied to the *sale* of "accounts."[33] Revised Article 9 continues this rule.[34] Current Article 9 defines "accounts" to include only payment obligations arising out of the sale or lease of goods or the provision of services.[35] Under current law, this leaves many kinds of payment rights within the definition of "general intangible." The *sale* of these types of payment rights also often serves as a financing transaction, but Current Article 9 does not apply to these transactions.

The licensee's payment obligations under a license or a "lease" of software are a "general intangible" under current law because no goods or services are involved. The licensee's payment obligations under a license or a lease are *not* "chattel paper" under either current[36] or new[37] law because the definition of chattel paper continues to require a security interest in or lease of "specific goods."[38]

#### 2. Revised Article 9

Revised Article 9 seeks to facilitate these financing transactions.

Section 9-102(a)(75) defines "software" as "as a computer program and any supporting information provided in connection with a transaction relating to the program. The term does not include a computer program that is included in the definition of goods."

31. The test is easy to apply when considering the software that may run the braking system in a car. It is more difficult to apply when considering a television set that can access the Internet.

32. *See* R. § 9-102(a)(42).

33. *See* U.C.C. § 9-102(1)(b).

34. *See* R. § 9-109(a)(3).

35. *See* U.C.C. § 9-106.

36. *See id.* § 9-105(1)(b).

37. *See* R. § 9-102(a)(11).

38. As discussed below in connection with purchase money security interests ("PMSIs"), in specified circumstances, a security interest in or "lease" of software may form a part of chattel paper, as may a monetary obligation with respect to software used in the goods.

Revised Article 9 broadens the definition of "accounts" to include

- payment obligations arising out of the sale, lease, or license of all kinds of tangible and intangible property (for example, "accounts" will include license fees payable for the use of software), and
- credit card receivables.[39]

Thus, under Revised Article 9, a licensee's payment obligations under a license or a "lease" of software are an "account" because the definition of "account" no longer requires a sale or lease of "goods."[40] The broader definition of "account" expands the scope[41] of Article 9 by bringing into Article 9 more transactions through the continued application of Article 9 to the sale of "accounts" (as newly defined).[42]

Under Current Article 9, the sale of a licensor's right to payment under a license is *not* a "security interest" because the definition of that term covers the *sale* of accounts and chattel paper but not the sale of general intangibles.[43] The sale[44] of a licensor's rights *is* a "secu-

39. *See* R. § 9-102(a)(2).

40. *See id.*

41. The scope of Article 9 has expanded in other, similar ways. The inclusion of many kinds of payment rights in the definition of "accounts" does leave behind in the definition of "general intangible" some important types of payment rights, such as payment rights that arise out of loan agreements that do not constitute "instruments." Revised Article 9 calls a general intangible where the obligor's "principal" obligation is the payment of money a "payment intangible." *See id.* § 9-102(a)(61). The sale of a payment intangible often functions as a financing transaction. Revised Article 9 brings certainty to these transactions by bringing the *sale* of a "payment intangible" into the scope of Article 9. *See id.* § 9-109(a)(3). However, to permit financial institutions that sell loan participations to avoid the need by buyers of loan participations to file uninformative financing statements against sellers, who would in many cases otherwise be subject to thousands of filings, Article 9 provides for the automatic perfection of a security interest created upon the *sale* of a payment intangible (but not a security interest given to secure an obligation). *See id.* § 9-309(3).

The sale of a promissory note will also often function as a financing transaction. Revised Article 9 recognizes this fact and treats the *sale* of a promissory note as a transaction subject to Article 9. *See id.* § 9-109(a)(3). Revised Article 9 defines a "promissory note" as a subset of "instruments." *See id.* § 9-102(a)(65) "Promissory notes" include "promises," but not "order paper" (e.g., checks). *See id.* As with the *buyer* of a payment intangible, the *buyer* of a promissory note enjoys automatic perfection of its security interest. *See id.* § 9-309(4). Unlike payment intangibles where there is nothing to possess and the first buyer of the payment intangible will always have priority, a buyer of a promissory note that relies on automatic perfection and does not take possession of the promissory note may lose to a subsequent buyer of the promissory note that does take possession of the promissory note. *See id.* § 9-330(d). That secured party will also lose to a holder in due course of the promissory note. *See id.* § 9-331.

42. Revised Article 9 also clarifies that a *seller* of accounts (and other property where the sale is an Article 9 transaction) retains no interest in the property sold. *See id.* § 9-318(a). This rejects the holding in *Octagon Gas Systems, Inc. v. Rimmer*, 995 F.2d 948, 955-56 (10th Cir. 1993). *See* PEB COMMENTARY NO. 14, TRANSFER OF ACCOUNTS OR CHATTEL PAPER (§ 9-102(1)(b)) (1994).

43. *See* U.C.C. § 9-102(1)(b).

44. Under Current and Revised Article 9, if a "sale" of a payment right (or other property)

rity interest" under Revised Article 9 because a licensor's rights under a license would come within the expanded definition of "accounts." Revised Article 9 continues to cover the *sale* of accounts *and* chattel paper (along with sale of payment intangibles and promissory notes).[45]

### *B. The Transfer of Payment Rights*

#### 1. Transfers of Intangibles

Current section 9-318(4) renders ineffective any restriction prohibiting the assignment of an account (which includes the creation of a security interest) or the creation of a security interest in a general intangible for money due or to become due.[46] Current section 9-318 permits the free assignment of a right to money, without restriction. Revised Article 9 builds on this in sections 9-406 and 9-408.[47]

#### 2. Limitations on Antiassignment Provisions

Revised Article 9 renders wholly ineffective any restriction in an account, promissory note, payment intangible, or chattel paper, or under other law, that would interfere with the

- creation or perfection of a security interest[48] in the right to payment, or
- enforcement of the secured party's security interest in the right to payment.[49]

includes significant recourse by the financing party against the licensor (or other characteristics not consistent with a "true sale"), the "sale" in substance may constitute a traditional loan by the financing party to the licensor, secured by the licensor's rights under the license. *See* U.C.C. § 9-502 cmt. 4; R. § 9-318 cmt. 2.

45. *See* R. § 9-109(a)(3). Because a "sale" by a licensor of its payment rights under the license (a sale of "accounts") will be a "security interest" under Revised Article 9, the buyer (the financing party) will have to file a financing statement naming the seller (the licensor) (as "debtor") to protect the buyer against *other* buyers from the seller (the licensor) and secured parties of the seller (the licensor) if the other buyer or secured party files a financing statement before the first buyer files a financing statement. *See id.* § 9-322(a)(1). A sale of payment intangibles and a sale of promissory notes will also be a "security interest" but will be automatically perfected and will automatically defeat lien creditors and most other secured parties. *See id.* § 9-309(3)-(4).

46. Current Article 9 does not invalidate a provision affecting the *sale* of a general intangible consisting principally of a right to payment because Current Article 9 does not apply to the *sale* of these rights. Plainly the same policy would apply.

47. Section 9-408 is discussed below.

48. These rules do *not* apply to the *sale* of a payment intangible or a promissory note. *See* R. § 9-406(e). The next section of this article (concerning section 9-408) describes the rules that apply to the *sale* of that type of collateral.

49. *See id.* § 9-406(d), (f). Subsections (d) and (f) of section 9-406 provide:

Thus, section 9-406 permits the creation and enforcement of a security interest in a right to payment arising out of a general intangible, including a license of software, even if the contract or other law restricts the licensor's right to assign its right to payment.

### 3. No Material Impairment Test Is Necessary

Some suggested that the licensor's right to assign its payment rights should be subject to a test based on whether the assignment materially affected the licensee's expectation of return performance. The concern here is that if a licensor can assign its right to receive money, the licensor may lose its incentive to perform its future obligations under the license, to the detriment of the licensee. Of course, the licensor's ability to obtain cash in exchange for the assignment of the payment rights will often provide the funds for the licensor to perform those obligations. Section 9-406 carries forward the rule of Current section 9-318(4), which has permitted unfettered security interests in these kinds of rights to payment since Article 9 became effective, with no apparent ill effects on the account debtor. Section 9-406 reflects the strong public policy in favor of the assignability of the right to receive money because this enhances the value of the accounts as collateral (to the benefit of the debtor and the account debtor).

Other legal rules are consistent with section 9-406. Section 317 of the *Restatement (Second) of Contracts*, which does refer to a material

> (d) . . . [A] term in an agreement between an account debtor and an assignor or in a promissory note is ineffective to the extent that it:
>
> (1) prohibits, restricts, or requires the consent of the account debtor or person obligated on the promissory note to the assignment or transfer of, or the creation, attachment, perfection, or enforcement of a security interest in, the account, chattel paper, payment intangible, or promissory note; or
>
> (2) provides that the creation, attachment, perfection, or enforcement of the security interest may give rise to a default, breach, right of recoupment, claim, defense, termination, right of termination, or remedy under the account, chattel paper, payment intangible, or promissory note.
>
> . . . .
>
> (f) . . . [A] rule of law, statute, or regulation that prohibits, restricts, or requires the consent of a government, governmental body or official, or account debtor to the assignment or transfer of, or creation of a security interest in, an account or chattel paper is ineffective to the extent that the rule of law, statute, or regulation:
>
> (1) prohibits, restricts, or requires the consent of the government, governmental body or official, or account debtor to the assignment or transfer of, or the creation, attachment, perfection, or enforcement of a security interest in the account or chattel paper; or
>
> (2) provides that the creation, attachment, perfection, or enforcement of the security interest may give rise to a default, breach, right of recoupment, claim, defense, termination, right of termination, or remedy under the account or chattel paper.

impairment test in respect of assignment of contractual rights, recognizes, in citing Article 9, that "[w]hen the obligor's duty is to pay money, a change in the person to whom the payment is to be made is not ordinarily material."[50] UCC section 2A-303 states, in the context of a "true lease," that a lessor's assignment of a right to payment owed by the lessee, in and of itself, as a matter of law is *not* a material impairment of any rights or obligations of the obligee for purposes that would render an antiassignment clause in a true lease effective.[51]

A material impairment test would be a significant and unexpected burden on secured financings. In financing and capital markets transactions, holders of performed and unperformed rights to payment customarily finance and securitize those rights. Lenders and investors financing unperformed rights to payment account for the credit risk that the account debtor will not perform its obligation to pay. But the lenders and investors financing both performed and unperformed rights to payment would not normally account for the risk, at least without considerable due diligence and greater expense, that the assignment of the rights to payment itself is *ineffective* by virtue of being a material impairment.

There is no justification for applying a material impairment test that might nullify a security interest in a licensor's fully earned right to payment under a license. Even UCC section 2-210(2), which does contain a material impairment test for the assignment of rights in the context of the sale of goods, would permit the assignment of "a right arising out of the assignor's due performance of his entire obligation." Indeed, this would be the case under UCC section 2-210(2) even if the sales contract itself prohibited assignment. In any event, Article 2 defers all of its provisions to Article 9,[52] and thus no Article 2 material impairment test would apply to an Article 9 transaction under Current Article 9.

### 4. The Licensee Is Protected

The licensee has other protections. If the circumstances are such that the licensee is concerned legitimately about the ability of a licensor that assigns rights to payment under Article 9 subsequently to perform unperformed license obligations, it is possible that the licen-

50. RESTATEMENT (SECOND) OF CONTRACTS § 317 cmt. d (1981).

51. *See* U.C.C. § 2A-303(3).

52. *See* U.C.C. § 2-402(3) ("Nothing in this Article shall be deemed to impair the rights of creditors of the seller (a) under the provisions of the Article on Secured Transactions (Article 9) . . . ."); *see also* R. § 2-210(3) (as revised as part of the Article 9 revisions).

see would have reasonable grounds for insecurity. The licensee might then demand that the licensor provide adequate assurances of the licensor's future performance to the licensee.[53]

In any event, if the licensor fails to perform and the license does not contain a "hell or high water" provision relating to payments by the licensee, the licensee's obligation to pay the assignee (the secured party) remains subject to any right of recoupment the licensee may have against the licensor arising out the same transaction and may also be subject to setoff rights.[54] Thus, the licensee can reduce the amount it owes to the assignee of the licensor by the amount of the licensee's damages arising out of the licensor's nonperformance.[55]

#### 5. Waiver of Defense Clauses

It is not clear under current law whether a waiver of defenses by an account debtor on a license of software is enforceable because Current section 9-206 expressly validates waivers only by "buyers" and "lessees" of goods and may displace non-Article 9 rules that would otherwise validate the waiver.[56] Revised Article 9 will validate these clauses generally.[57] Such agreements can be made by all account debtors.[58] Under Revised Article 9, the waiver is effective for the benefit of the assignee of the original holder of the right to payment.[59]

## IV. SECURITY INTEREST IN A LICENSEE'S RIGHTS UNDER A LICENSE

### *A. The Right to Create and Perfect the Security Interest*

#### 1. What Revised Article 9 Does

Revised Article 9 also seeks to facilitate the ability of a licensee of intellectual property to obtain financing secured by its rights under

53. *See* RESTATEMENT (SECOND) OF CONTRACTS § 251; UNIF. COMPUTER INFO. TRANSACTIONS ACT § 708 (1999); *cf.* U.C.C. § 2-210(5), 2-210 cmt. 6 (nonassigning party to agreement entitled to "due assurance" that any delegated performance will be forthcoming); U.C.C. § 2A-303 cmt. 5.

54. *See* U.C.C. § 9-318(1); R. § 9-404(a).

55. *See* R. § 9-404(a)(1). A secured party would typically require a "hell or high water" provision.

56. *See* U.C.C. § 9-206(1).

57. *See* R. § 9-403. This is consistent with the better view of current law.

58. Persons who owe an obligation under an account, chattel paper, or general intangible. *See id.* § 9-102(a)(3).

59. *See id.* § 9-403. The statute takes no position concerning the rights of the original holder of the right to payment and leaves that question to the general law of contracts.

the license. Revised Article 9 renders ineffective a restriction on the transfer of a *licensee's* rights under a license[60] in the contract or arising under other law, *to the extent* the restriction would interfere with the creation, attachment, or perfection of the security interest.[61] Revised Article 9 does *not* interfere with the enforceability of an otherwise effective restriction (in the contract or under other law[62]) on the secured party's enforcement of its security interest in the license of the general intangible.[63]

Existing law generally permits creation and perfection of security interests in otherwise nontransferable rights.[64] The Drafting Committee modeled its approach on the law that applies to FCC licenses. Well-established law permits creation, attachment, and perfection of

60. Section 9-408, instead of section 9-406 (discussed above), in addition to applying to a security interest in a licensee's rights under a license, also applies to restrictions on the *sale* of payment intangibles and promissory notes. The application of Article 9 to these transactions is new. The application of section 9-408 to sales transactions assures account debtors under a payment intangible and obligors under a promissory note that nothing under Article 9 will, in the ordinary course, interfere with the account debtor's ability to continue to deal with the original holder of the obligation. If the original holder of the payment intangible or promissory note uses the payment obligation to secure an obligation, then section 9-406 will apply and it is possible that a foreclosure of that security interest would require the account debtor or maker to deal with the person that acquires the payment intangible or promissory note at the foreclosure sale. Of course, in the circumstances of a promissory note, Article 3 may require the maker of the promissory note to deal with a new holder of the note.

61. *See* R. § 9-408(a), (c). Subsections (a) and (c) of section 9-408 provide:

> (a) . . . [A] term in a promissory note or in an agreement between an account debtor and a debtor which relates to a health-care-insurance receivable or a general intangible, including a contract, permit, license, or franchise, and which term prohibits, restricts, or requires the consent of the person obligated on the promissory note or the account debtor to, the assignment or transfer of, or creation, attachment, or perfection of a security interest in, the promissory note, health-care-insurance receivable, or general intangible, is ineffective to the extent that the term:
>
> (1) would impair the creation, attachment, or perfection of a security interest; or
>
> (2) provides that the creation, attachment, or perfection of the security interest may give rise to a default, breach, right of recoupment, claim, defense, termination, right of termination, or remedy under the promissory note, health-care-insurance receivable, or general intangible.
>
> . . . .
>
> (c) A rule of law, statute, or regulation that prohibits, restricts, or requires the consent of a government, governmental body or official, person obligated on a promissory note, or account debtor to the assignment or transfer of, or creation of a security interest in, a promissory note, health-care-insurance receivable, or general intangible, including a contract, permit, license, or franchise between an account debtor and a debtor, is ineffective to the extent that the rule of law, statute, or regulation:
>
> (1) would impair the creation, attachment, or perfection of a security interest; or
>
> (2) provides that the creation, attachment, or perfection of the security interest may give rise to a default, breach, right of recoupment, claim, defense, termination, right of termination, or remedy under the promissory note, health-care-insurance receivable, or general intangible.

62. *See, e.g.*, RESTATEMENT (SECOND) OF CONTRACTS § 317 (1981).

63. *See* R. § 9-408(d).

64. *See, e.g.*, U.C.C. § 9-318(4).

a security interest in the licensee's rights under an FCC license and proceeds of that right, subject to the FCC's control over the actual enforcement of that security interest by the FCC's exercise of its power to approve or disapprove a transferee.[65] The law that applies to FCC licenses permits the enforcement of the security interest in the *proceeds*,[66] but not the enforcement of the security interest in the FCC license itself, without the consent of the FCC.[67] Surely the public policy supporting the interest of the FCC in supervising who acts under an FCC license is no less worthy of protection than the interest of a software licensor in supervising who acts under a software license.

#### 2. What Revised Article 9 Does Not Do

There are many things that Revised Article 9 does not do in connection with permitting the creation and perfection of a security interest in a licensee's interest. Revised Article 9 does *not* preempt contrary federal law. Revised Article 9 does not permit or enable a licensee to grant a security interest in the *licensor's* property. A security interest granted by a licensee attaches only to the licensee's "rights in the collateral."[68] As stated in Official Comment 6 to section 9-203:

> A debtor's limited rights in collateral, short of full ownership, are sufficient for a security interest to attach. However, in accordance with basic personal property conveyancing principles, the baseline rule is that a security interest attaches *only* to whatever rights a debtor may have, broad or limited as those rights may be.[69]

### *B. Limitations on Enforcement*

#### 1. Restrictions on Foreclosure

Section 9-408 permits a secured party to *create and perfect* a security interest in a licensee's *rights* under a license despite otherwise enforceable prohibitions in the license or under other law against transfers.[70] The Drafting Committee designed section 9-408 to make the value of otherwise nonassignable rights under a license available to licensees so they can obtain more credit (and be more likely to pay

65. See, for example, *MLQ Investors L.P. v. Pacific Quadracasting, Inc.*, 146 F.3d 746, 748 (9th Cir. 1998), and decisions cited in that opinion.

66. The security interest is created and perfected in the entire interest of the licensee.

67. *See MLQ Investors*, 146 F.3d at 748.

68. R. § 9-203(b)(2).

69. *Id.* § 9-203 cmt. 6 (emphasis added).

70. *See id.* § 9-408(d)-(e).

their debts, including license fees).

Subsection 9-408(d)[71] provides that nothing in section 9-408 overrides[72] an otherwise enforceable contractual provision or rule of law outside of Article 9 that would limit the secured party's ability to *enforce* its security interest.[73] The Drafting Committee specifically designed this balanced approach to respond to the concerns of licensors[74] that a secured party not be able to *use* the licensee's rights under the software license without the consent of the licensor.[75]

71. Section 9-408(d) provides:

To the extent that a term in a promissory note or in an agreement between an account debtor and a debtor which relates to a health-care-insurance receivable or general intangible or a rule of law, statute, or regulation described in subsection (c) would be effective under law other than this article but is ineffective under subsection (a) or (c), the creation, attachment, or perfection of a security interest in the promissory note, health-care-insurance receivable, or general intangible:

(1) is not enforceable against the person obligated on the promissory note or the account debtor;

(2) does not impose a duty or obligation on the person obligated on the promissory note or the account debtor;

(3) does not require the person obligated on the promissory note or the account debtor to recognize the security interest, pay or render performance to the secured party, or accept payment or performance from the secured party;

(4) does not entitle the secured party to use or assign the debtor's rights under the promissory note, health-care-insurance receivable, or general intangible, including any related information or materials furnished to the debtor in the transaction giving rise to the promissory note, health-care-insurance receivable, or general intangible;

(5) does not entitle the secured party to use, assign, possess, or have access to any trade secrets or confidential information of the person obligated on the promissory note or the account debtor; and

(6) does not entitle the secured party to enforce the security interest in the promissory note, health-care-insurance receivable, or general intangible.

72. This language does not contain affirmative prohibitions on the secured party's enforcement of the security interest because it does not need to. Section 9-408 is an *exception* to the enforceability of contract and legal restrictions on transfer. Absent the application of this *exception*, any otherwise enforceable contractual or legal restriction on transfer remains in place and enforceable. Article 9 does not interfere with the enforcement of those restrictions. Nor is it the role of Article 9—designed to facilitate secured lending—to impose its own restrictions on transfer.

73. This achieves exactly the same result as occurs under Article 2A with respect to the leasing of goods. Section 2A-303(3) renders ineffective a prohibition in a personal property lease prohibiting creation (or enforcement) of a security interest *only* where there is "an *actual* transfer by the lessee of the lessee's right of possession or use of the goods." The creation and perfection is effective and no default under the lease occurs by reason of the creation or enforcement of the security interest, in the absence of an "actual transfer" of use or possession. *See* U.C.C. § 2A-303(3). This is the equivalent of the rule in Revised section 9-408 permitting creation and perfection, but not enforcement (in the face of an otherwise effective contractual or non-Article 9 legal prohibition).

74. Section 9-408 makes frequent references to the "account debtor." Section 9-102(a)(3) defines "account debtor" to include "a person obligated on . . . [a] general intangible." Thus, the term "account debtor" can refer to the licensor or the licensee, depending on the context. *See* R. § 9-408 cmt. 5.

75. Earlier in the drafting process, section 9-408(d) had a subsection stating that the licensee's creation of a security interest in its rights under the license does not create a security inter-

There are many things that Article 9 of itself does not permit the secured party to do in connection with the enforcement of its security interest. Significantly:

- Revised Article 9 does *not* permit the secured party to *enforce* in any way[76] the security interest in the licensee's rights under the license *if* other law prohibits enforcement or other law would enforce a contractual restriction on enforcement.[77]
- Revised Article 9 does *not* permit the secured party to have access to the licensor's proprietary or confidential information as a result of the licensee granting a security interest in its rights under the license.[78]

Article 9 does not interfere with the licensor's ability to control who will actually use the license. An otherwise effective term of the license prohibiting enforcement will remain effective and any attempt to enforce a security interest in that circumstance will result in a default.[79] As stated in Official Comment 6 to section 9-408:

est in the *licensor's* rights. In July 1998, NCCUSL specifically considered and by a floor vote decided to eliminate this provision. The elimination of the subsection was not a disapproval of the rule stated in that subsection. The provision was not necessary because it is inherent in Article 9 that a security interest attaches only to a *debtor's* rights in collateral. Section 9-203 expressly provides this rule. *See id.* § 9-203(b)(2). In a software license, the licensee's rights are those rights it has under the license. The licensee has no rights in the licensor's intellectual property itself.

76. Section 9-207 permits a secured party in "possession" of collateral to use the collateral to the limited extent necessary to preserve its value. *See id.* § 9-207(b)(4)(A). There was a suggestion that the Drafting Committee should make section 9-207 expressly subject to section 9-408, which preserves specific limits on a secured party's ability to use general intangibles (including software). Section 9-207 applies only to tangible collateral, as intangibles are not susceptible of "possession." *See id.* § 9-207 cmt. 7. In narrow circumstances, software is included in the definition of goods (when the software is appropriately embedded or integrated into related hardware). *See id.* § 9-102(a)(44). In those few circumstances, the obligations (and rights) of a secured party in possession of the hardware would encompass the embedded software. Otherwise, software is a "general intangible" not subject to "possession." *See id.* § 9-102(a)(42). Thus, section 9-207 does not apply to software. In any event, under ordinary principles of statutory construction, the very specific rules of section 9-408(d) would not be overridden by the general rules of section 9-207.

77. *See id.* § 9-408(d).

78. *See id.*

79. Article 9 generally does not prevent a senior secured party from declaring a breach of the security agreement if the debtor violates a negative pledge clause. *See id.* § 9-401(b). Some suggested that the licensor should have the same kind of right. The rule of section 9-408 is different from the negative pledge clause because under Article 9 a senior secured party is required to recognize a junior secured party, has duties (and potential liabilities) to a junior secured party, and has the risk of the junior secured party causing the loss of the collateral. *See id.* §§ 9-601 to 9-624. This is the reason that it is appropriate for a senior secured party in that circumstance to have a right to declare a breach. When a licensee grants a security interest in its rights, the licensor does *not* have to recognize the secured party and the secured party has *no* right to use the license. As a result, the licensor has no risk of liability to the licensee's secured

> *However, subsection (d) ensures that these affected persons are not affected adversely.* That provision removes any burdens or adverse effects on these persons for which any rational basis could exist to restrict the effectiveness of an assignment or to exercise any remedies. For this reason, the effects of subsections (a) and (c) are immaterial insofar as those persons are concerned.[80]

### 2. Grabbing the Proceeds

Once the licensee's rights have been transformed into money, the licensor no longer has an intellectual property interest to protect. If the licensee does transfer its rights (for example, with the consent of the licensor, pursuant to a bankruptcy court order[81] or otherwise), the secured party is entitled to enforce its security interest in the *proceeds* generated by a transfer of the licensee's rights.[82] That does not interfere with the licensor's interest in controlling who uses the licensee's rights under the license.[83]

### 3. The Licensor Can Enforce the Balance of the License

As noted above, a secured party of the licensee would have a security interest only in whatever rights the licensee has under its license. Except as stated in section 9-408, nothing in Article 9 cuts off the licensor's contract rights against the licensee. The licensee's default[84] under the license would trigger whatever contractual termination rights the licensor has. Except for the ability of a secured party to obtain and perfect a security interest in the licensee's rights under the license, the creation and perfection of the security interest in favor of the licensee's secured party in the licensee's rights would have no effect on the rights of the licensor. Indeed, nothing in section 9-408 prevents the licensor from providing that the secured party's enforcement efforts trigger a default under the license to the extent contemplated by section 9-408(d).

party.

80. *Id.* § 9-408 cmt. 6 (emphasis added).

81. Note that the Bankruptcy Court may lack the power to permit the licensee to transfer its rights without the consent of the licensor. *See* Perlman v. Catapult Entertainment, Inc. (*In re* Catapult Entertainment, Inc.), 165 F.3d 747, 754-55 (9th Cir. 1999).

82. The security interest was created and perfected in the licensee's entire interest under the license.

83. *See* R. § 9-408 cmts. 7-8.

84. Excluding, as a result of section 9-408, any assertion that a default under the license can be based on the secured party's obtaining or perfecting its security interest.

## V. LICENSEES IN ORDINARY COURSE OF BUSINESS

### *A. Protecting "Ordinary Course" Transactions*

#### 1. What Section 9-321 Is About

Article 9's effort to facilitate commerce sometimes requires the protection of people other than a secured party or the borrower. For example, an owner of a motion picture (a producer, for example) may grant a security interest in the owner's intellectual property.[85] The owner may then enter into an exclusive license with a distributor of the firm. The distributor too may grant a security interest in its rights as a licensee. The distributor may then enter into nonexclusive licenses with exhibitors.[86] Alternatively, the owner may enter into nonexclusive licenses with distributors or directly with exhibitors or end-users.[87] The holders of "off-the-shelf" nonexclusive licenses likely have reasonable expectations that (as long as they perform their obligations) they will continue to have the right to use the license even if their licensor loses *its* rights as a result of a foreclosure by the licensor's secured party.

#### 2. What Section 9-321 Does

Section 9-321[88] provides (in part) that a *nonexclusive* licensee (but *not* an *exclusive* licensee) of a general intangible (including a copyright) in ordinary course of business "takes free" of a security interest created by its immediate licensor.[89] Thus an ordinary course

85. That property would, in significant part, likely be a copyright.

86. Under current practices, a security agreement between a secured party and a producer or a secured party and a distributor will often authorize the borrower to enter into licenses of the type protected by section 9-321. Distribution agreements also frequently provide contractually that the licensor cannot terminate any end-user licenses that were entered into prior to the default by the distributor that resulted in termination of the distributor's license.

87. A similar structure might occur in software distribution.

88. Section 9-321 provides in part:

(a) In this section, "licensee in ordinary course of business" means a person that becomes a licensee of a general intangible in good faith, without knowledge that the license violates the rights of another person in the general intangible, and in the ordinary course from a person in the business of licensing general intangibles of that kind. A person becomes a licensee in the ordinary course if the license to the person comports with the usual or customary practices in the kind of business in which the licensor is engaged or with the licensor's own usual or customary practices.

(b) A licensee in ordinary course of business takes its rights under a nonexclusive license free of a security interest in the general intangible created by the licensor, even if the security interest is perfected and the licensee knows of its existence.

89. To the extent the license included copyrighted material, it seems quite possible that the Copyright Act would preempt the application of section 9-321 to a license in this circumstance.

*nonexclusive* license will survive the secured party's foreclosure against *its* licensor.[90] As discussed below, for policy reasons a nonexclusive licensee should have this protection.[91]

### 3. What Section 9-321 Does Not Do

Section 9-321 affects the relative rights of a secured party and a licensee from the secured party's borrower. It has no effect on the relative rights of a licensor and its licensee. Thus, it has no effect on a provision in a license that prohibits a licensee from entering into nonexclusive sublicenses.[92] Nor does it protect a nonexclusive sublicensee who obtains its sublicense from the licensee of the borrower.

### 4. So, How Does This Work?

Thus, in the example given above, an exhibitor holds a nonexclusive license granted by a distributor that holds an exclusive license from a producer. If the distributor's secured party forecloses, the nonexclusive licensee would continue to enjoy its rights under the license (assuming it performs its obligations). If the producer's secured party forecloses, however, the distributor holding a subsequent-in-time, exclusive license would lose its rights. The rights of the exhibi-

*Peregrine* and *Avalon* suggest so. *See* National Peregrine, Inc. v. Capitol Fed. Sav. & Loan Ass'n (*In re* Peregrine Entertainment, Inc.), 116 B.R. 194, 199 (C.D. Cal. 1990); *In re* Avalon Software, Inc., 209 B.R. 517, 521 (Bankr. D. Ariz. 1997); *see also* 3 NIMMER & NIMMER, *supra* note 6, at § 10.07[B] n.40 ("Note that 'recordation of transfer' [of the copyright mortgage] will give priority to such transfer as against a nonexclusive license taken after such recordation."). This article does not attempt to analyze that question.

90. Some form of this provision has been in every draft of Revised Article 9 since 1996 and also of UCITA since the first draft of UCITA in January 1996 (it has been dropped from UCITA as part of the removal of all secured financing provisions from UCITA). It does not appear that anyone raised any objection to it during the discussions of UCITA's financing provisions during meetings of the UCITA Drafting Committee.

91. A secured party can seek to prevent even a nonexclusive licensee from obtaining the rights under the license "free" of the security interest by appropriate contract agreements with the licensor in the security agreement. A nonexclusive licensee in the ordinary course can achieve that status only if it meets the tests of section 9-321(a), including the absence of knowledge of the negative covenant in the security agreement (though knowledge alone of the existence of the security interest is not disqualifying).

92. Although such a provision would, of course, be most unlikely since by definition section 9-321 only comes into play with respect to nonexclusive licenses granted in the ordinary course. Thus, section 9-321 would have no effect in the non-Article 9 software financing structures described above. *See supra* Part II.D. In those transactions, the licensor could place a provision in its license to the financed licensee that any sublicense entered into by the licensee must include a provision terminating the sublicense if the licensor or the financing party terminates the license held by the financed licensee. The provision would likely go on to provide that any sublicense that did not include such a provision was invalid. Nothing in Article 9 would have any effect on the enforceability of that provision. That provision would remain enforceable if the licensor sold its rights to a finance company (captive or otherwise).

tor, as a nonexclusive sublicensee, would also fall because section 9-321 protects it only as against the secured party of its immediate sublicensor (the distributor).[93]

### *B. So What Does "Takes Free" Mean?*

The phrase "takes free" does not mean that the nonexclusive licensee gets a "free" license. The nonexclusive licensee may continue to use the license following the secured party's foreclosure against the licensor *only* if the nonexclusive licensee complies with all of the terms (including payment of license fees to the person that acquired the licensor's interest at the foreclosure sale) of the license. Thus all of the licensee's obligations remain in place and the licensor's successor may terminate the license for nonperformance by the licensee.

### *C. How Do We Know When a License is "Nonexclusive"?*

Article 9 does not contain a definition of "nonexclusive" license. If UCITA has been enacted in the relevant jurisdiction, it would seem likely that a court might look to UCITA's definition of a "nonexclusive" license. UCITA has a very narrow definition of "nonexclusive" license in section 102(a)(48). Thus, the corresponding meaning of "exclusive" license is very broad. Under UCITA, a license does not qualify as "nonexclusive" if it in any way "precludes" the licensor from entering into another license with another licensee within the same "scope."[94] UCITA in turn defines "scope" to include the "use" of the licensed information.[95] Thus, any license that prevents the licensor from entering into any other license within the same "scope" is an "exclusive" license. Accordingly, if a license contains any restriction on the licensor's right to enter into a competitive license, the license is "exclusive" and section 9-321 would not provide the exclusive licensee with any protection.

It is also likely that a court would look to well-established law under the Copyright Act for guidance as to the meaning of "nonex-

93. However, under the "shelter" doctrine, if a nonexclusive licensee did qualify for protection under section 9-321 from a foreclosure conducted by a secured party of the nonexclusive licensee's licensor, any person that had a sublicense from the nonexclusive licensee would be protected to the same extent. *See generally* U.C.C. § 3-203(b), 3-203 cmt. 2 (transferee of instrument obtains rights of transferor, including any status of transferor as a holder in due course).

94. *See* UNIF. COMPUTER INFO. TRANSACTIONS ACT § 102(a)(48) (1999).

95. *See id.* § 102(a)(61)(B); *see also* U.C.C. § 2B-209 cmt. 5 (Draft Feb. 1999) ("rights to a screen play for use in television" is a "scope" issue).

clusive" license. As noted in *Nimmer on Copyright*, there is "no limit on how narrow the scope of licensed rights may be" and still constitute an "exclusive license."[96] Thus, with UCITA, copyright law gives a very narrow definition to a nonexclusive license and a correspondingly broad definition to an exclusive license.[97]

This common sense meaning fits well with the purposes of section 9-321—to protect "off the shelf," ordinary course transactions with the borrower's customers. If a license contains restrictions on the licensor's ability to enter into other licenses, it is highly likely some negotiation is going on between the licensor and the licensee. In this circumstance, it is not unreasonable to expect that the licensee should have to deal with the licensor's secured party.[98]

### *D. Why Protect Ordinary Course of Business Licensees?*

Section 9-321[99] seeks to balance two legitimate interests:

- the ability of a secured party to have recourse to its collateral, and
- the ability of an ordinary course of business licensee of the collateral to retain the licensee's rights without interference from the secured party of the licensor.

Article 9 balances these interests by protecting the customer when the customer is a direct customer of the borrower. However, Article 9 protects the secured party when the customer is not a direct customer of the debtor of the secured party. Article 9 favors the secured party in the latter circumstance not because downstream customers are not worthy of protection but because in those circumstances the burden on the secured party to attempt to control a downstream sublicensor outweighs the benefits to the downstream customer.

It would not be fair to a secured party for remote transactions to

96. 3 NIMMER & NIMMER, *supra* note 6, at § 10.02[A].

97. *See id.*

98. It has been suggested that all oral licenses, even if exclusive in substance, are "nonexclusive" licenses because of section 204(a) of the Copyright Act. *See* 17 U.S.C. § 204(a) (1994). That section does not say that. It says that if the content of a license is "exclusive," then the exclusive license is not enforceable unless it is in writing. It does not convert oral exclusive licenses into oral nonexclusive licenses. A "licensee" under an exclusive oral license gets nothing. The holder of an oral license has an enforceable license only if the holder can prove that the owner of the copyright granted the oral licensee a *nonexclusive* license.

99. This is a rule of convenience in line with numerous statutory, common, and civil law rules protecting innocent ordinary course transferees. *See* U.C.C. § 2A-307(3); U.C.C. § 9-307; R. § 9-320.

adversely affect its rights. The secured party is in a position to monitor and influence by contract the activities only of its borrower. The secured party does not have any contractual rights against remote parties. At the same time, it is fair to protect the direct customer of the secured party's borrower because the secured party is in a position to oversee the activities of its borrower. Thus, Article 9 imposes on the secured party the risk of its own borrower's activities but not the risk of the activities of remote persons. The actions of remote downstream customers would not affect the secured party's security interest.

This reflects a balancing of the interests, expectations, and burdens of the various participants. For example, it indicates that a prudent secured party should "police" its own borrower against the borrower entering into nonexclusive licenses. However, it does not require the secured party to "police" its borrower's licensees against entering into nonexclusive sublicenses because that would place too great a burden on the secured party. At the same time, it protects the reasonable expectations of nonexclusive licensees (generally nonnegotiated transactions) that their rights are not subject to termination as a consequence of the licensor's default. Section 9-321 provides a statutory rule that implements what the secured party and the licensor undoubtedly expect—the secured party will routinely authorize the licensor to enter into ordinary course transactions. That, after all, is the business the licensor runs. However, even that expectation interest is outweighed by the burden that would be imposed on the original licensor's secured party if it had to "police" the sublicensing activities of all exclusive licensee's. Finally, the rules adopt a policy that it is not asking too much for an exclusive licensee (who is more likely to be negotiating its deal) either to make a deal with the licensor's secured party to protect the exclusive licensee or to take its license subject to the security interest granted by the licensor.

If the secured party to the licensor does not want to encourage nonexclusive licenses, it can, in its security agreement (or elsewhere), require the borrower (the licensor) to place in all of the nonexclusive licenses the borrower grants a provision that the nonexclusive license will terminate if the licensor's secured party forecloses. Nothing in section 9-321 or elsewhere in Article 9 would interfere with the enforcement of such a provision as between the secured party and its borrower. Ordinarily, of course, the borrower is in the business of granting nonexclusive licenses and the secured party expects the borrower to use the fees paid under those licenses to pay the secured

debt.

This is a perfectly logical allocation of the risks and burdens and this allocation has been widely used in the UCC since its adoption.[100] This rule mirrors the existing rules for buyers and lessees of goods.[101]

### *E. Winning and Losing*

Revised section 9-321 works very well in the common distribution structures for motion pictures. There, the owner of intellectual property grants a security interest in the intellectual property to a secured party who perfects its security interest. Typically in a motion picture transaction, the owner of the intellectual property (the producer) may grant a security interest in its intellectual property and then enter into an exclusive license with a distributor, who in turn may enter into nonexclusive sublicenses. Under section 9-321, if the owner of the intellectual property defaults under its obligation to the secured party, the secured party can foreclose and "wipe out" the exclusive license. The nonexclusive sublicense falls with the exclusive license because 9-321 protects nonexclusive licensees *only* from those security interests granted by their immediate licensor (here the distributor).[102]

A secured party financing a licensor[103] would "lose" if the licensor entered into a nonexclusive license agreement with, say, a distributor, who would then "take free" of the secured party's security

100. Some have said that licenses of software should work like real estate leases—if a lender to an owner of real estate forecloses on the real estate, any leases entered into following the recording of the deed of trust or mortgage will be "wiped out." Similarly they argue, so should a *nonexclusive* license entered into after the licensor has granted a security interest in its intellectual property. This is an inapt analogy. A lease of real property is like an *exclusive* license because only one tenant can occupy any piece of real property at any one time. Article 9 is to the same effect: an *exclusive* license of intellectual property *is* "wiped out" by the foreclosure of a prior security interest in the intellectual property. Prospective tenants of real estate who contemplate making major investments in their tenancies are accustomed to protecting their quiet enjoyment vis-à-vis mortgagees. That rule places no undue burden or cost on the transaction.

101. There has also been some suggestion to limit this rule to nonexclusive licensees who are consumers. Current law has no such limitation for ordinary course lessees and buyers of goods. *See* U.C.C. § 2A-307(3); U.C.C. § 9-307(1). All ordinary course buyers of goods, lessees of goods, and nonexclusive licensees of software are entitled to this protection. The rationale explained above provides no basis for limiting this to consumer transactions. This rule has nothing to do with bargaining power; it is based on reasonable expectations and efficiency grounds. Thus it is equally appropriate in commercial and consumer transactions.

102. *See* R. § 9-321(b).

103. As noted above, this is only relevant if the Copyright Act does not preempt these issues to the extent the collateral includes copyrights. The *Nimmer* treatise, *Peregrine*, and *Avalon* suggest quite strongly that preemption does occur. *See supra* note 89.

interest in the licensed general intangible.[104] It is most likely, as a business matter, that a distributor would enter into a nonexclusive license. Again, if the license is exclusive, Revised section 9-321 would not apply.

Even in the unlikely event that an owner of intellectual property and its distributor might enter into a nonexclusive license, the owner's secured party could seek to protect the buyer at the foreclosure sale by requiring in the security agreement with the licensor that all licenses entered into by the licensor contain a provision providing for the termination of the license in the event the secured party forecloses. If, nevertheless, the owner of the intellectual property entered into an ordinary course of business nonexclusive license with a distributor, then that is what the distributor would have—a nonexclusive license. When the secured party foreclosed against the producer, the buyer at the foreclosure sale would acquire all of the producer's rights and would be free to enter into any license the secured party felt like entering into with any person. Upon foreclosure, the buyer at the foreclosure sale would become entitled to all performance (including payment obligations) that the nonexclusive licensee owed to the borrower (licensor).

## VI. PMSIs

### *A. PMSIs in Intellectual Property*

Revised Article 9, like Former Article 9, provides statutory superpriority to a purchase money security interest ("PMSI") in goods. As discussed below, this superpriority now expressly includes software when there is a PMSI in related hardware. The Drafting Committee considered whether to extend superpriority to PMSIs in software generally. The Drafting Committee decided not to do that. If a secured party that has a security interest in software desires superpriority, it can seek to obtain a subordination agreement with the prior secured party.[105] Today, with respect to goods, software, or any other kind of collateral, a secured party who provides new value and perfects its security interest after another secured party has perfected its security interest will commonly negotiate an intercreditor agreement with the first secured party.

104. That is, the distributor would have the right to use the license for so long as it complies with all terms of the license, including paying all license fees to the secured party.

105. *See* U.C.C. § 9-316; R. § 9-339.

### *B. The History of Software PMSIs Under Revised Article 9*

Due to insufficient certainty about the reach of current law on the subject, many experienced Article 9 lawyers are unwilling under current law to rely on the availability of a statutory superpriority for a PMSI in software.[106] Before any consideration of how to treat software, the Drafting Committee made a considered decision to resolve the ambiguity under Current Article 9 by limiting superpriority to PMSIs in "goods." The Drafting Committee did not believe that the marketplace indicated a need to have the purchase money superpriority apply to other types of collateral.

Later, the Article 9 Drafting Committee invited representatives of leading software financing institutions to make a presentation on the issue of PMSIs in software to the Drafting Committee. Those persons did so. The Drafting Committee then discussed, at two meetings, how to proceed. The Article 9 Drafting Committee decided not to provide for PMSIs in software generally.

### *C. Limited Software PMSIs*

In recognition of the arguments made by these lenders, the Drafting Committee did decide to provide superpriority to PMSIs in software when combined with a PMSI in related hardware. This probably expands the availability of purchase money superpriority from that available under current law. As a result, those providing financing for the acquisition of software (and the related hardware) receive a special benefit under Revised Article 9. Software is the *only* intangible for which superpriority is provided under a PMSI. The exception permits a PMSI in software if the debtor acquired its interest in the software

- for the principal purpose of using the software on hardware in which the secured party also has a PMSI, *and*
- in an integrated transaction with the acquisition of the related hardware.[107]

106. *See* U.C.C. § 9-312(4). This subsection refers to the debtor's "possession" of the PMSI collateral. This suggests that this means that PMSI priority is not available for intangible collateral that the secured party cannot "possess."

107. *See* R. § 9-103(c).

### *D. Why Limited Availability of Software PMSIs Does Not Matter*

#### 1. Superpriority by Agreement

The current PMSI provisions provide for a statutory superpriority for certain collateral under specified conditions.[108] In all situations, however, under both Current and Revised Article 9, a secured party can obtain priority by agreement.[109]

#### 2. No Limitations on Other Aspects of the Security Interest

The limited availability of obtaining a PMSI in software does not prevent a lender financing the licensee's acquisition of rights in software from obtaining a security interest in the licensee's rights in the software (facilitated by section 9-408 as discussed above) and thereby defeating any claims of a licensee's bankruptcy trustee.[110] The limitation affects only the matter of superpriority

#### 3. PMSIs in Software Would Not Help Much

Under Current Article 9, a PMSI in a licensee's right to use software may not do the secured party much good. Most decisions under Current Article 9 do not treat rights arising under an agreement for the short-term use of collateral (which might well include a license) as "proceeds" of the property used.[111] The courts may conclude that a sublicense may not be "proceeds" of a sublicensor's rights under a license under current law because the creation of the sublicense does not involve a "disposition" of the master license.[112] Thus, under current law, the only benefit of permitting a PMSI in a licensee's rights in software would be to create PMSI superpriority in the license itself. The security interest probably would not extend to the payment rights arising from a sublicense (as putative "proceeds" of the license).

Even if the sublicense to the end-user constituted "proceeds" of the license, the PMSI superpriority would not extend to those proceeds. Under current law, the superpriority applies to "proceeds" of

108. *See* U.C.C. § 9-312(3)-(4).

109. *See id.* § 9-316; R. § 9-339.

110. As discussed above, many financing arrangements by licensors for licensees do not create a "security interest." In these circumstances, the licensor may consider itself much better off as a non-Article 9 creditor that can exercise its termination right without regard to the foreclosure rules in Article 9.

111. *See, e.g.*, CLC Equip. Co. v. Brewer (*In re* Value-Added Communications, Inc.), 139 F.3d 543, 546 (5th Cir. 1998).

112. *See* U.C.C. § 9-306(1); PEB COMMENTARY NO. 9, LEASE RENTALS AS PROCEEDS (1992) (lease payments for goods constitute "proceeds" of the goods).

PMSI inventory collateral only to the extent the proceeds are cash received on or before "delivery" of the collateral by the borrower to the end-user.[113] The PMSI superpriority does not extend to accounts, chattel paper, instruments, or other "proceeds."

Asset-based lenders routinely have a negative covenant in their loan agreements prohibiting other secured lending, including PMSI lending. Thus, under Current Article 9, even if the superpriority extended to other "proceeds," it would not avoid the need to seek approval to obtain the PMSI from an existing blanket lender who has obtained a negative covenant.

Under Revised Article 9, a secured party with a security interest in software already fares much better than under prior law, even without PMSI superpriority.[114] A license *is* "proceeds" of the licensor's intellectual property under Revised Article 9, which includes the rights to payment under a "license" in the definition of "proceeds."[115] So at least under Revised Article 9, a security interest in the intellectual property will continue in the rights arising out of a license or a sublicense and the secured party (or other successor) who acquires the collateral upon foreclosure will step into the debtor's shoes with the right to enforce those rights. The superpriority for goods (as inventory) does *not* extend to accounts arising from the use of the collateral.[116] Similarly, even if a secured party could obtain a PMSI in a licensee's rights, the PMSI superpriority in software would not extend to amounts owed under a sublicense. To that extent the superpriority would have only a limited benefit.[117] Nothing in Revised Article 9 would affect the enforceability of the senior lender's negative covenant against other security interests, including a PMSI.

### 4. PMSIs Are Not Necessary

When a licensor "finances" its licensee, as discussed above, the

113. *See* U.C.C. § 9-312(3). The PMSI superpriority does extend to proceeds of noninventory PMSI collateral, such as equipment. *See id.* § 9-312(4). Presumably, if a PMSI in software had been allowed under Revised Article 9, the inventory rules would have applied.

114. Although a financier may consider itself still better off as a non-Article 9 party in one of the structures discussed above.

115. *See* R. § 9-102(a)(64)(A).

116. The security interest, however, does remain *attached* to the accounts as "proceeds" of the license.

117. Master licensors could try to force distributors to modify their business practices to require notes for payment so the superpriority would continue in those notes. Then, if the licensee's blanket secured party perfected only by filing, the PMSI secured party could take possession of the notes and defeat the blanket security interest. This is cumbersome, and it seems unlikely that most end-users would agree to deliver a note.

license transaction itself generally is not a "secured transaction." The licensor's right to terminate the license is not subject to Article 9 rules nor is it affected by prior or subsequent security interests granted by the licensee to its secured party. Thus, under current law, the licensor's termination right outside of Article 9 gives the licensor every bit as much protection as it would have with a PMSI because the PMSI superpriority does not extend beyond the master license for the several reasons identified above. Under the new law, the same protection is provided.

## CONCLUSION

Revised Article 9 facilitates the financing of intellectual property and in the process carefully balances the interests of licensors, licensees, and secured parties. The results are practical and fair.