Software Financing Update: Issues of Concern to Software Vendors

To structure a software financing transaction acceptable to both the lessor and the software vendor, understanding accounting rulings such as SOP 97-2 and FAS 140 is crucial.

An article dealing with the drafting and legal issues that arise in software leasing and financing transactions could cover many possible topics. Among the most important are the issues typically raised by the software vendor. This article deals with three categories of those issues:

1. accounting issues that can impose limitations on how the legal contract is drafted;
2. limitations imposed by federal intellectual property law;
3. issues under Article 9 of the Uniform Commercial Code (Current Article 9), including the effect of Revised Article 9 of the Uniform Commercial Code (Revised Article 9).

First, let's review the software financing transaction. Regardless of what the documentation is called—lease, loan, installment payment agreement, etc.—a software lease or financing transaction is usually treated as either an unsecured or a secured financing, in each case facilitating the lessee's acquisition of a nonexclusive license to use the software. A software lease is rarely treated as a true lease. The primary goals of the lessor are to have a right to terminate the lessee's use of the software and related services if the lessee misses a payment and, if at all possible, to have some remarketing rights with respect to the software license. To achieve these goals the lessor must have a contract with the software vendor. But that is where the difficulty arises, as software vendors are loathe to grant these rights and remedies to a lessor.

The software vendor must refer customers to the lessor and let the lessor document the financing transaction, as opposed to generating leases in-house and then assigning them to the lessor.

Revenue Recognition and SOP 97-2

A primary goal for many public software companies is to recognize revenue up-front, as opposed to recognizing revenue as the payments become due. If a lessor approaches a software vendor with a proposal for an assignment-type vendor program, or for remarketing assistance or some other form of credit support for a potential lessee that is a perceived credit risk, the lessor will undoubtedly hear: "Can't do it—it's a revenue recognition issue." Let's examine this objection in more detail.

While there are many welcome changes in Revised Article 9, lessors financing software must wait for legislative reform for relief from the restrictions of federal intellectual property law.

ASSIGNMENT-TYPE VERSUS REFERRAL TYPE VENDOR PROGRAM—

Many software companies must comply with the American Institute of Certified Public Accountants ("AICPA"), Statement of Position 97-2 (SOP 97-2), which governs software revenue recognition. One of the requirements for revenue recognition is that the vendor's fee be fixed and determinable. Paragraph 28 of SOP 97-2 provides that "if payment of a significant portion of the software licensing fee is not due until...more than twelve months after delivery, the licensing fee should be presumed not to be fixed or determinable." This presumption can be overcome, however, if the software vendor can show a "history of successfully collecting under the original payment terms without making concessions." Subsequent interpretations have made it clear that refunds or concessions to either the customer or an unrelated financing party will prevent revenue recognition.

For software vendors just getting started with a vendor program, this means that they must outsource the software finance program to a leasing company in a referral-type program, not an assignment-type program. In other words, the software vendor must refer customers to the lessor and let the lessor document the financing transaction, as opposed to generating leases or installment payment contracts in-house and then trying to assign them to the lessor. Once the software vendor has sufficient payment history, it can bring the vendor program in-house and an assignment-type program should be feasible.

RECOURSE AND CONCESSIONS—

As mentioned above, the software vendor will not be able to recognize revenue if it has a history of making concessions to either the customer or an unrelated financing party. Concessions may take many forms, including, without limitation, a decrease in the license fee; extending the payment due dates; providing free services, upgrades, or products not included in the original license; indemnification of a financing party beyond the indemnification provided to the customer in the license; or a guaranty of the customer indebtedness. An interest rate buy-down or "blind discount," however, would not be considered a concession if it is contemporaneous with the customer license transaction.

In addition, the following actions do not necessarily result in a refund or concession:

- introducing a customer to a financing party and facilitating their discussions;
- representing that the software vendor has clear title to the software (so long as the software vendor makes the same representation to the customer); and
- taking action to terminate the license, so long as the action was explicitly authorized by the customer in the license.

Note, however, that there may be some circumstances where recourse may be appropriate. For example, generally speaking, the software vendor can recognize revenue with respect to services only as the services are performed. Therefore, if the financing party requires recourse as to fees for unperformed services, this should not adversely affect revenue recognition if structured properly, since the software vendor could not recognize the service revenue up-front anyway.

There are also some situations where the deal is unlikely to get done without recourse or other concessions because of the customer's weak credit. The financing party could suggest that it is appropriate for the software vendor to make some concessions and recognize revenue ratably if the alternative is not to do the deal at all. Some software vendors have been willing to make some concessions in these types of situations.

True Sale Issues Under FAS 140

If a software vendor generates a financial asset internally (e.g. receivables under a license agreement or an installment payment agreement) and then sells that financial asset to a financing party, the sale must comply with FAS 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," for the software vendor to account for the transaction as a sale as opposed to a secured borrowing.

A detailed discussion of FAS 140 is beyond the scope of this article. Suffice it to say that if the software vendor has "continuing involvement" with the transferred assets or the transferee, then the software vendor may not be able to obtain true sale treatment. Continuing involvement may take many forms, including recourse, servicing arrangements, repurchase obligations, and pledges of collateral, although no one of these

factors is fatal in itself if limited appropriately. The final determination of whether or not there is a true sale depends upon the facts and circumstances of each case and involves a complex analysis of facts and law.

The classic means of satisfying the requirements for a true sale is to use a two-step securitization structure where the software vendor creates a special purpose, bankruptcy remote subsidiary (SPE) to which it sells the software receivables. This sale to the SPE is straightforward and without recourse, although the software vendor needs to adequately capitalize the SPE. The SPE then sells the software receivables to the financing party in a second sale transaction that may or may not satisfy the requirements for a true sale, due to potential recourse to the SPE. However, so long as the first sale from the software vendor to the SPE is a true sale, the software vendor can treat the transaction as a sale and not a secured borrowing. It is possible in theory to have a true sale to a financing party in a one-step transaction, but it is much more difficult to argue that the software vendor does not have continuing involvement with the transferred assets and the transferee.

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Federal Intellectual Property Law

Nonexclusive licenses of patents and copyrights are not transferable by the licensee without the licensor's consent. What this means is that the licensee cannot grant the financing party effective remarketing rights without the consent of the software vendor. As a practical matter, if the financing party wants to be able to remarket the software license, it should start by carefully reading the license. Some licenses are transferable by their express terms, such as with many small ticket software licenses or in system integration transactions. Otherwise, the financing party must seek the software vendor's consent to remarket the software license.

If remarketing rights are desired, it would be prudent to seek consent from the software vendor at the time of the financing and not wait until the time of a default by the lessee. However, given that there is no secondary market for many kinds of software, the financing party usually requests that the software vendor enter into a remarketing agreement pursuant to which the software vendor agrees to assist in the remarketing of the software on a best efforts or commercially reasonable efforts basis. This remarketing obligation, however, may be viewed as a concession under SOP 97-2, so many software vendors are unable to enter into remarketing agreements without jeopardizing revenue recognition.

Revised Article 9 of the UCC

As many readers are no doubt aware, many of the definitions in Current Article 9 have been substantially revised as part of the new Revised Article 9 that takes effect on July 1, 2001, in many states. For example, the definition of "goods" is expanded under Revised Article 9 to include software embedded in goods. Note, however, that federal law still preempts conflicting state law, so not even Revised Article 9 can overrule the case law providing that nonexclusive licenses cannot be transferred without consent of the licensor and that security interests in copyrights and copyright royalties must be perfected by filing with the United States Copyright Office. As a result, while there are many welcome changes in Revised Article 9, lessors who are financing software must continue to wait for federal legislative reform for relief from the restrictions of federal intellectual property law.

This article has barely scratched the surface of the many software accounting rules that affect how software financing transactions are documented, and the federal intellectual property rules limiting a lessor's rights to remarket software. Clearly, to successfully structure a software financing transaction with the maximum protection for the lessor and still provide for revenue recognition to the software vendor, it is absolutely essential to understand the accounting rulings such as SOP 97-2 and FAS 140. It is also critical to understand the limitations imposed by federal intellectual property law. Armed with this knowledge, however, it has been and should continue to be possible to structure a software financing transaction with an acceptable degree of risk to the lessor. ELT

ELT thanks William S. Veatch, Partner at Cooley Godward LLP for this month's column.