APPENDIX 8 - SOFTWARE

The most troublesome categorical problem under the present language of Article Nine arises when the secured party is financing the supplier/licensor of software. To the extent that the sale of a software package to a user or other consumer makes the *medium* of the software predominant, it is likely to be considered a sale of goods.[1] If the software provided does not involve hardware and appears to be custom-made for the licensee, involving the licensor directly in the licensee's needs and business patterns, the software license may be viewed as a "service" contract.[2] Under either of these scenarios, the resulting income stream produces a section 9-106 "account" not a "general intangible." Otherwise, the income streams from other more passively transmitted and typical forms of intellectual property are "general intangibles" under current language because they do not fit within either the "goods" or "services," predicate for an "account." Typically, but not always, these sale or licensing income streams also fall outside the Article Nine documentary categories of "instruments,"[3] and

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[1] Computer Servicenters, Inc. v. Beacon Mfg. Co., 328 F. Supp. 653, *aff'd*, 443 F.2d 906 (4th Cir. 1971); Systems Design & Management Information, Inc. v. Kansas City Post Office Employees Credit Union, 14 Kan. App.2d 266, 788 P.2d 878, 11 UCC2d 775 (1990); Wharton Management Group v. Sigma Consultants, Inc., 1990. LEXIS 54 (Del. Super 1990), *aff'd* 582 A.2d 936 (Del. 1990); Geotech Energy Corp. v. Gulf States Telecommunications & Information Systems, Inc., 788 S.W.2d 386 (Tex. App. 1990); Micro-Managers, Inc. v. Gregory, 147 Wis.2d 500, 434 N.W.2d 97 (Ct. App. 1988); Data Processing Services, Inc. v. L.H. Smith Oil Corp., 492 N.E.2d 1329, 1 UCC 29 (Ind. App. 1986). The sale of goods classification predominates and is used even when the software is custom tailored. *See, e.g.,* Advent Sys., Ltd. v. Unisys Corp., 925 F.2d 670 (3d Cir. 1991). Revised Article Nine explicitly defines "software" and places it within the broader category of "general intangibles." U.C.C. [Revised] § 9-102(a)(42)&(75).

[2] Conopco, Inc. v. McCreadie, 826 F. Supp. 855, 870-71 (D.N.J. 1993). *See also* Rodau, *Computer Software: Does Article 2 of the Uniform Commercial Code Apply?*, 35 EMORY L.J. 853, 864-74 (1986).

[3] These income streams are generally not "instruments." Rights to payment that arise out of assignments or licenses of intellectual property might be, but are not typically, captured in negotiable instruments or in other documents "of a type" which are "in ordinary course of business ... *transferred by delivery with any necessary endorsement or assignment*." U.C.C. § 9-105(1)(I) (Emphasis added). *See also* U.C.C. [Revised] § 9-102(a)(47). The author has been informed that some lawyers are advising their secured creditor clients to require the client's debtor/borrowers to force its [the debtor's] account debtors to sign negotiable instruments in favor of the debtor/borrower that can, in turn, be possessed by the secured creditor. Under Article Nine, *possession* is a proper mode of perfection for a negotiable instrument regardless of the debtor's location. Even if the obligation captured in the instrument arose out of an account debtor's obligation to pay

"chattel paper."[4]

As the next section explains, Revised Article Nine solves the categorical goods/intangibles problem in the current case law by defining software as a general intangible,[5] and at the same time, expanding the

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for the use of intellectual property, Article Nine perfection by possession should hold as applicable law. The decision in the *Peregrine* case concludes that the recording provisions of the Copyright Act displace Article Nine perfection with respect to copyright receivables. National Peregrine, Inc. v. Capital Federal Savings & Loan Ass'n., 116 B.R. 194, 199 (C.D. Cal. 1990). However, this conclusion should not disturb the Article Nine rule on perfection of instruments by possession for two reasons:

1. The Ninth Circuit's decision in the *Broadcast Music* case seems to critically undermine the premise of *Peregrine* with respect to copyright receivables. *See* Broadcast Music, Inc. v. Hirsch, 104 F.3d 1163, 1166 (9th Cir. 1997)("Assignments of interests in royalties have no relationship to the existence, scope, duration or identification of a copyright, nor to 'rights under a copyright.'").

2. In any case, the receivables rule in *Peregrine* should not reach an obligation once it is formed by the account debtor into a negotiable instrument. Such an obligation to pay losses much of its prior relationship with the consideration for the underlying obligation. It is transformed into an obligation to pay separate from its source and different from its prior intangible status as an "account" or "general intangible." *See* U.C.C. § 9-304, cmt. 1; U.C.C. [Revised] § 9-313, cmt. 2. Instruments held as collateral are not collected routinely without the direct participation of the secured party. Except for temporary purposes, including presentment for collection, instruments must be in the possession of the secured party in order to be "perfected" against third party claims. U.C.C. § 9-304(1),(4)&(5). *But see* U.C.C. [Revised] § 9-312(a) (Instruments can be perfected by filing). Although a proper filing can perfect a security interest in an instruments under the Revisions, that form of perfection still leaves the secured party vulnerable to both ordinary course purchasers who give new value and to subsequent holders-in-due-course. U.C.C. [Revised] § 9-330(a) & § 9-331(a)&(c).

4 "Chattel paper" is another kind of documented right to payment that has its own collateral category under Article Nine. Rights to payment that arise out of intellectual property transfers will generally not be considered chattel paper because under the current Article Nine language, chattel paper must include a security interest or lease in specific *goods* in support of the monetary obligation running to the debtor who, in turn, wants to use this right to payment as collateral. U.C.C. § 9-105(1)(i). *See In re* Latin Investment Corp., 156 B.R. 102 (Bankr. D.D.C. 1993). *Accord* U.C.C. [Revised] § 9-102(a)(47). However, because certain software products are treated as "goods" under the current Article Nine language, the documents evidencing a monetary obligation that is, in turn, secured by these products can qualify as the obligee/debtor's "chattel paper." Chattel paper is not created under Revised Article Nine when these kinds of documentary obligations are secured by software because software is defined as a "general intangible" under the Revisions. However, the definition of "chattel paper" is expanded by the Revisions to include collateral rights in "a security interest in or lease of specific goods or *of specific goods and software used in the goods*." U.C.C. [Revised] § 9-102(a)(11)(Emphasis added). *See* U.C.C. [Revised] § 9-102(a)(42)&(75).

5 U.C.C. [Revised] § 9-102(a)(42).

definition of an "account" to include all income streams from the sale or licensing of intellectual property.[6]

The Draft version of Revised Article Nine that was approved by National Conference of Commissioners on Uniform State Laws at their July 30, 1998 meeting amended the "general intangible" definition by expressly adding the word "software" to this category of collateral.[7] Revised Article Nine also includes the following definition of "software" in section 9-102(a)(75): "Software" means 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 contained in goods unless the goods are a computer or computer peripheral.[8]

The phrase "computer program" is critical to understanding the scope of the new "software" definition and thus the new definition of a "general intangible." Revised Article Nine does not define "computer program." However, the definition of "computer program" can arguably be borrowed from the more complete set of software-related definitions in the proposed Uniform Computer Information Transactions Act ("U.C.I.T.A.").[9] Guided by these parallel U.C.I.T.A. definitions, "software" under the Article Nine Revisions includes "source code."[10] If "source code" can safely be placed within the definition of a "general intangible" under new section 9-102(a)(42), then Revised Article Nine overrules those cases that treat computer source code as "goods" for Article Nine filing purposes.[11]

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[6] U.C.C. [Revised] § 9-102(a)(2).

[7] DRAFT FOR APPROVAL, REVISION OF UNIFORM COMMERCIAL CODE ARTICLE 9 - SECURED TRANSACTIONS § 9-102(a)(42)(National Conference of Commissioners on Uniform State Laws, July 24-31, 1998)(With Prefatory Note and Reporter's Notes). The definition of a "general intangible" in the Proposed Final Draft of Revised Article Nine, submitted earlier to the American Law Institute at its May 1998 meeting, expressly added only one category of collateral- a "payment intangible" - to the otherwise residual definition. PROPOSED FINAL DRAFT, UNIFORM COMMERCIAL CODE - REVISED ARTICLE NINE - SECURED TRANSACTIONS § 9-103(b) (Proposed Final Draft, April 15, 1998).

[8] U.C.C. [Revised] § 9-102(a)(75). The term "computer program" is not defined in the final version of Revised Article Nine.

[9] Formerly proposed U.C.C. Article 2B. *See* DRAFT, UNIFORM COMMERCIAL CODE - ARTICLE 2B - LICENSES § 2B-102(a)(6) (Discussion Draft, August 1, 1998).

[10] *See supra* note 8.

[11] Computer Servicenters, Inc. v. Beacon Mfg. Co., 328 F. Supp. 653, *aff'd*, 443 F.2d 906 (4th Cir. 1971); Systems Design & Management Information, Inc. v. Kansas City Post Office Employees Credit Union, 14 Kan. App.2d 266, 788 P.2d 878, 11 U.C.C. 2d 775 (1990); Wharton Management Group v. Sigma Consultants, Inc., LEXIS 54 (1990), *aff'd* 582 A.2d 936 (Del. 1990); Geotech Energy Corp. v. Gulf States Telecommunications & Information Systems, Inc., 788 S.W.2d 386 (Tex. App. 1990); Micro-Managers, Inc. v. Gregory, 147 Wis.2d 500, 434 N.W.2d 97 (Ct. App. 1988); Data Processing Services,

A number of cases have concluded that "software" in general and "source code" in particular, should be treated as "goods" under the Commercial Code. When this rule is applied, Article Nine forces the secured party to file in the location when the goods are located to perfect its interests. Finding find the "situs" of some physical thing or embodiment that can reproduce itself and can thus have many locations, for example software and source codes, can be nearly impossible to determine.

Intangible property, however, is conceptually separate from its host embodiment. This principle has been recognized by the United States Supreme Court[12] and by Congress.[13] Even when this duality of property principle is recognized, however, the distinction between intangible intellectual property and its tangible embodiment has been difficult for Courts to make in cases involving computer source code and software. The arrangement of commands in a source code has meaning only as it reacts to the physical capabilities of a particular machine. This interdependence has led one Bankruptcy Court to conclude that source code has no abstract existence apart from the *tangible* machines in which it effects *tangible* changes.[14]

Arguably the source code for any particular application acts like a mechanical key to unlock the capabilities of the hardware. These codes seem to be part of their host hardware. Nevertheless, this view ignores the reason why the source code has value as collateral. The primary value of the source code exists apart from any *single* machine. It derives its value from its usefulness as a command sequence for many similar machines. Without the ability to generate multiple copies of the source code it is a solitary hardware component. For the owner of the source code, the essence of the work's value is in the ability to generate multiple copies, or license others to do so.[15] This ability and control functionally describes the protected intellectual property captured in the work. If the real value of source codes does indeed stem from the fact that the source codes contain a sequence of commands and other expressions capable of making many machines more useful, it is intellectual property separate from its embodiment, at least to the extent that the exclusive right to control such further use can be separately owned.[16]

Inc. v. L.H. Smith Oil Corp., 492 N.E.2d 1329, 1 UCC 29 (Ind. App. 1986).

12 Stevens v. Gladding, 58 U.S. 447, 452 (1854).

13 17 U.S.C. § 202 (1988).

14 See *In re* Bedford Computer Corp., 62 B.R. 555, 567 (Bankr. D.N.H. 1986).

15 *See In re* Information Exchange, Inc. 98 B.R. 603, 604-05 (Bankr. N.D. Ga. 1989). (*Information Exchange* may go too far in the other direction by suggesting that the material object or copy has no separate value.)

16 Advanced Marketing Services, Inc. v. Dayton Data Processing, Inc., 1992 Ohio App. LEXIS 994 p. 20 (Ohio App. 2d Dist., March 6, 1992). ("Transfer of ownership of any

Guided by this principle, Revised Article Nine defines "software" and classifies it as a "general intangible."[17]

material object, including the copy or phonorecord in which the work is first fixed, does not of itself convey any rights in the copyrighted work embodied in the object...." The *AMSI* court concluded that a buyer of custom tailored software bought one copy of the software and documentation but that such purchase was separate and distinct from the rights of the copyright owner.)

[17] U.C.C. [Revised] § 9-102(a)(42)&(75). Although the definition of "software" relies on the meaning of terms not defined in Revised Article Nine, the definition seems to include source code.