Two Approaches to Financing Software

John R. Herrmann
Assistant General Counsel, Bank of America
231 S. LaSalle St., 8th Floor
Chicago, IL 60697
312-828-1748 (tel)
312-974-7012 (fax)
john.r.herrmann@bankofamerica.com

The author is indebted to Timothy Clarke, Associate General Counsel for Bank of America in its Business Capital unit, and Jonathan Fleisher, Esq., of CasselsBrock in Toronto, Ontario, for their input to this paper.

Overview

The following is a description of the types of intellectual property financing engaged in by two units at Bank of America. One unit (Global Vendor Finance) provides financing to customers of software and service providers and the other unit (Business Capital) provides financing to middle market manufacturing companies; occasionally these companies are the owners of intellectual property.

There are other sources and structures for financing software companies and their customers. The sources discussed herein illustrate two approaches taken by Bank of America.

First Approach – Financing Customers of the Software Companies

In this approach, the financier assists those who manufacture products ("vendors") in getting their products into the marketplace by providing financing to the end-users of those products. While this type of financier exists to serve the vendors and considers the vendors to be its customers, the financing is provided to, and the credit strength relied upon is that of the end-users of the products (the "Licensees").[1]

The working model in providing financing to Licensees is to provide financing to companies whose credit ratings are generally strong for products that can be labeled "essential use", that is, which fulfill an important need for the Licensees to keep their enterprise operating. For the most part, financing of this type is unsecured.

Over the past decade, the business has evolved in response to revisions to the accounting rules concerning the recognition of revenue by those entities licensing, selling, leasing and otherwise marketing computer software. Formerly the licensor, relying on its own credit analysis or that of the financier, provided in its software licenses that the Licensees could make royalty payments for the use of the software over a period of time. The then-existing accounting rules generally allowed the licensor to capitalize the entire revenue stream and recognize a sale to the Licensee. The financier then purchased the receivables (the royalty payments) from the licensor and collected them from the Licensee.

In 1997 that method began to change based on the publication of Statement of Position (SOP) 97-2 by the American Institute of Certified Public Accountants (AICPA). SOP 97-2 (since modified, but not in a material way for purposes of this presentation) provides that the software manufacturer / licensor generally cannot recognize the revenue during the current year for royalty payments that are owed to it more than twelve months after

[1] **Banc of America Leasing-Global Vendor Finance ("GVF")** is the largest bank-owned vendor finance organization in the United States and is part of the reason why Banc of America Leasing is the largest bank-owned and 6th largest equipment financing/leasing company overall in the U.S. As of the end of 2006, GVF had over $4.4 billion in assets under management. Last year, GVF extended almost $400 million of credit to those seeking to acquire the right to use software and related maintenance services ("Licensees") and its financing in this area was almost $100 million in the first quarter of 2007.

the date of the transaction. The statement requires persuasive evidence that an agreement exists, that delivery has occurred, that the vendor's price is fixed or determinable, and that collectibility is probable. In interpreting the latter two points, the accounting profession noted the phenomenon that payments due more than a year from the date of the transaction were sometimes subject to variation due to either Licensee cancellation privileges or a rewrite of the original transaction when the licensor provides an upgrade or modification. There is an exception if a manufacturer / licensor has established a history of collecting its extended term payments.

Some licensor/vendor companies have established the necessary history to continue to extend financing and transfer the receivables to financiers under the assignment of payments method. Those without an established history, however, request that the financier provide financing directly to the Licensees. In such a case, the financier satisfies the Licensee's total license fee or royalty obligation by making an up-front payment to the licensor, and simultaneously enters into a non-cancelable Installment Payment Agreement with the Licensee under which the Licensee repays the financier's advance over time.

<u>Documenting the Transaction</u>

Assignment method: Under this method, the financier takes an assignment from the licensor not only of the royalty payments owed by the Licensee to the licensor, but also of the licensor's rights of enforcement with respect to such payments. Usually the extended payment section is merely one section of a license agreement or a product schedule to a master license agreement. The financier looks for language that not only allows the licensor to assign the rights to payments while retaining its obligations to the Licensee, but requires the Licensee to waive its right to assert against the financier any claims or defenses that it may have against licensor. Such language is supported by UCC § 9-403. There is variation among the different licensors' license agreements with respect to the rights and remedies available when a Licensee fails to pay its royalty payments. Acceleration of remaining payments is not always provided for, but termination of the license usually is. Sometimes, the termination is supported by the right and ability of the licensor to enter the Licensee's premises and physically remove or verify the removal of the software whose license has been terminated.

Direct Contract (97-2) method: As noted above, the financier does not take an assignment of the payments due from the Licensee, but remits the total royalty amount at the inception of the license to the licensor in exchange for the Licensee's execution of an Installment Payment Contract. The Installment Payment Agreement ("IPA") is best characterized as a loan document. An important point worth stressing is the separation of the license agreement from the loan document. In an effort to bridge that chasm, the financier requests that the licensor and the Licensee amend the license agreement to provide that a default under the IPA is also a breach under the license, thereby allowing remedies such as termination of the license or of support services for the license to be exercised in the event of non-payment under the IPA. Such provisions require a strong contractual and working relationship between the financier and the licensor. The IPA form sometimes also provides for a grant by the Licensee to the financier of a limited security interest in the Licensee's right to use the software or, with licensor's consent, a conditional assignment of the license to the financier, and opens the door for a foreclosure of that right in the event of a default under the IPA.

Canadian counsel has advised that the Direct Contract method is preferable in Canada because of the lack of statutory support for a waiver of defenses clause.

Insolvency or Bankruptcy of Licensee

The ability to exercise remedies upon a default by the Licensee is adversely impacted by the automatic stay provisions of the U.S. Bankruptcy Code (the "Code"). In certain contexts other provisions of the Code benefit the financier. In these situations, the Licensee usually is forced to pay the financier in situations where the Licensee wants to continue to use the software during reorganization. It is in the bankruptcy context that the financier learns whether it correctly analyzed whether the software that it financed was "essential use" or not.

Assignment method: Of the two documentation methods, the assignment method provides a cleaner path to the financier's assertion of rights as the holder of an executory contract. The financier typically seeks to enforce rights of collection and enforcement that were assigned to it by the licensor. Under the license agreement, the licensor continues to license the software and may provide other services. The Licensee is obligated to pay the royalties and to refrain from any impermissible use (copying, for example) of the software. The license agreement fits the definition of an executory contract because continuing performance is due by both parties to the agreement. By agreement with the licensor, the financier can assert the rights licensor has with respect to the payments. The financier can seek an administrative expense claim for Licensee's continued use of the software during the pendency of the bankruptcy case and can force the Licensee to accept or reject the license agreement (and its schedules) upon plan confirmation.

Direct Contract (97-2) method: It can be difficult to categorize the IPA as an executory contract under § 365 of the Bankruptcy Code.[2] The IPA is not the license agreement and little performance is due from the financier under most forms of IPA. If the IPA is not an executory contract, the financier has limited leverage to force the Licensee to continue making payments. Occasionally, a court will award an administrative expense claim to prevent the Licensee debtor from being unjustly enriched. The more likely result is that the financier will be characterized as having an unsecured claim that is payable as part of a reorganization plan. However, since the Licensee has often granted the financier a security interest in its rights under the license agreement the financier may argue that it is a secured creditor, provided that the security interest has been perfected. The most likely benefit of such a secured creditor status occurs if the Licensee, with licensor's consent, sells its license rights to a third party in connection with its reorganization case. The financier has first claim on the proceeds of such sale, assuming it has recorded a UCC-1 financing statement and no other lender has a prior claim on the Licensee's general intangibles. Such other lender

[2] The author reserves the right to do so in an appropriate circumstance.

(the lender to all assets of a debtor) is described in the next section in the context of a loan to the licensor / manufacturer.

There is a greater risk in Canada. While in a traditional license arrangement the licensor must get paid during the reorganization period that benefit may not be extended to a financier via an assignment of the license which effectively turns the agreement into a financing agreement. Further, under current insolvency law a debtor need not pay a financing source to retain use of the product financed and need not accept or reject the use of the product as in the U.S.

Second Approach – Financing the Software Companies Directly

In asset-based lending, the lender ("Lender") lends against the borrower's assets based on a formula known as the borrowing base.[3] The formula usually provides for a loan of 85% of the value of borrower's qualifying receivables, a lesser percentage of the value of borrower's qualifying inventory, and varying percentages of the value of certain other assets of borrower. The Lender obtains a priority security interest in the assets it lends against.

Occasionally, the Lender will include some of the value of a borrower's intellectual property in the borrowing base, almost always in connection with a loan that is collateralized by the substantial majority of the borrower's other assets. The Lender's first step is to obtain an independent appraisal by a valuation firm of the intellectual property. The appraisal will give both an enterprise, or going concern, value and an orderly liquidation value (OLV). The Lender will generally lend up to 50% of the OLV, though there is a fair amount of subjectivity involved. It may depend on how important the trade name, trademark or other intellectual property is to the overall business.

The Lender records a patent and trademark security filing with the U.S. Patent Office and also includes the trade name or trademark as part of its description of general intangibles and other assets in the UCC-1 financing statement filed with the appropriate state official's office. If the trade name is sold, either in a bankruptcy proceeding or outside of it, the Lender has a claim on the proceeds in accordance with the priority of its liens.

As noted above, appraising intellectual property involves some subjectivity. In addition to obtaining an independent appraisal, the Lender will also look at how the borrower values the intellectual property on its balance sheet and in its business. Two decisions by the U.S. Supreme Court in April 2007 should have a negative impact on the valuation of patents (*AT&T v. Microsoft* and *KSR International v. Teleflex*). Per those cases, the Court is less likely to grant patent protection where there is lack of real innovation.

---

[3] **Bank of America Business Capital** provides asset-based financing. It provides working capital and other loans to middle market companies with sales ranging from $25 million to $2 billion per year. At the end of 2006 it had over $9 billion in outstanding loans.