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QUESTION: **HOW DO I MAKE SURE THE COMPANY GETS PAID WHEN IT PROVIDES SOFTWARE OR GOODS WITH EMBEDDED SOFTWARE ON CREDIT?**

ANSWER: **TAKE A PURCHASE MONEY SECURITY INTEREST IN THE SOFTWARE OR THE GOODS WITH THE EMBEDDED SOFTWARE AND MAKE SURE THE LIEN ALSO COVERS THE PROCEEDS OF THE GOODS AND SOFTWARE PROVIDED.**

For most of us, the notion of software as collateral seems odd. How would you ever repossess your collateral? How would you conduct a commercially reasonable sale of your collateral if you could figure out how to repossess it? If we think of software and goods containing software in the same way that we think of bulldozers and forklifts, we may miss business opportunities.

What if your company sold, leased or installed a software system that enabled a resort to automate and keep track of its reservations and room assignments? Or on the other hand, what if your company provided the software system for a health care provider to be able to properly code accounts and bill insurance companies and governmental entities for reimbursement of health care services provided to patients? If your customer in either event defaulted in paying for the software, you would be able to demand its return if your company had a properly perfected security interest in the software system. If the software system were not voluntarily returned, you could cause the sheriff's deputies to levy execution upon your collateral. While you might not want the software system back, having the right to take it away from your customer could very well result in payment to your company, even from a bankruptcy estate.

If your company hasn't provided the goods or software to the end user, these lien rights may be even more valuable. Often, goods and services are placed into the stream of commerce on credit terms. As value is added at subsequent layers in the distribution chain, more credit is provided commensurate with the additional value supplied. Ultimately, the goods and services reach users who pay for the goods and services received. Those payments then flow back through the chain of distribution to those who added value and ultimately to the original providers of goods and services. This cycle of credit and payment may also apply to providers of software and goods with embedded software designs.

While secured transactions can provide the ability to seize and sell specific collateral, secured transactions can also secure the proceeds of goods and software provided on credit. We can use provisions of the Uniform Commercial Code to capture the cash flow attributed to the value we have provided in software placed into the stream of commerce. If we provided the goods or software on credit or we provided the money to purchase the goods or software,

we have created "purchase money obligations." We can use those goods or software purchased with the credit we provided as our "purchase money collateral."

Why do we care about this nonsense? The Uniform Commercial Code states in Section 9-324.F.:

> Except as otherwise provided in subsection G of this section, <u>a perfected purchase money security interest in software has priority over a conflicting security interest in the same collateral</u>, and, except as otherwise provided in section 9-327, <u>a perfected security interest in its identifiable proceeds also has priority</u>, to the extent that the purchase money security interest and the goods in which the software was acquired for use has priority in the goods and proceeds of the goods under this section. (Emphasis added.)

The exception provided in subsection G of section 9-324 says that where there are competing security interests in software or goods containing software, the party actually providing the goods or software prevails over the party that loans the money to acquire that collateral. In other words, the trade creditor will take priority over the bank!

So how do we go about getting a priority purchase money security interest in the software or goods we provide and their proceeds? First, you need a Security Agreement that grants you the security interest in the purchase-money collateral and its proceeds. Second, you need to "perfect" your security interest.

So let's say that the software or goods with embedded software that you sell become the inventory of your customer. With respect to inventory, the priority of the purchase-money security interest extends to the same inventory, any chattel paper or instruments constituting proceeds of the inventory, and in proceeds of the chattel paper, with some exceptions. <u>Moreover, the properly perfected purchase-money security interest in inventory will retain its priority in identifiable cash proceeds of the inventory</u> so long as those proceeds are received on or before the delivery of the inventory to the buyers, if:

A.   The purchase-money security interest is perfected by the time your customer takes possession of the inventory;

B.   You send an authenticated notification to the holder of any conflicting security interest;

C.   The holder of the conflicting security interest receives your notification within five years before your customer obtains possession of the inventory; and

D.   The notification states that your company has or expects to obtain a purchase-money security interest in your customer's inventory and you properly describe the inventory, including the goods and software, in the notification.

So let's say you filed your UCC-1 Financing Statement with the Secretary of State and you perfected your security interest in the purchase-money collateral by the time your customer received the goods and software or within 20 days. Or, if the goods and software

became your customer's inventory, your company made sure that the UCC-1 Financing Statement was filed before the customer received possession of the inventory, and you sent your authenticated notification to anyone who held a conflicting security interest advising that within the next five years, your customer would receive possession of inventory of a certain described type in which your company expected to acquire a purchase-money security interest. If you do these things, you now have created a priority lien in the software or goods with embedded software that you are providing on credit. Even better, you also have priority lien rights to the identifiable proceeds of the goods and software provided. Your company gets the money before anyone else!

Keep in mind that the requirements to create priority liens in software and goods with embedded software and the proceeds of those items are complicated and must be followed strictly. Should your company or someone you know need assistance with the steps needed to properly perfect a purchase-money security interest, please feel free to call me.